

**PAYING PEOPLE NOT TO WORK:**

**THE UNEMPLOYMENT  
COMPENSATION SYSTEM**

**by**

**Raymond P. Thorne**

**NCPA Policy Report No. 133**

**July, 1988**

**The National Center for Policy Analysis**

**7701 N. Stemmons, Suite 800**

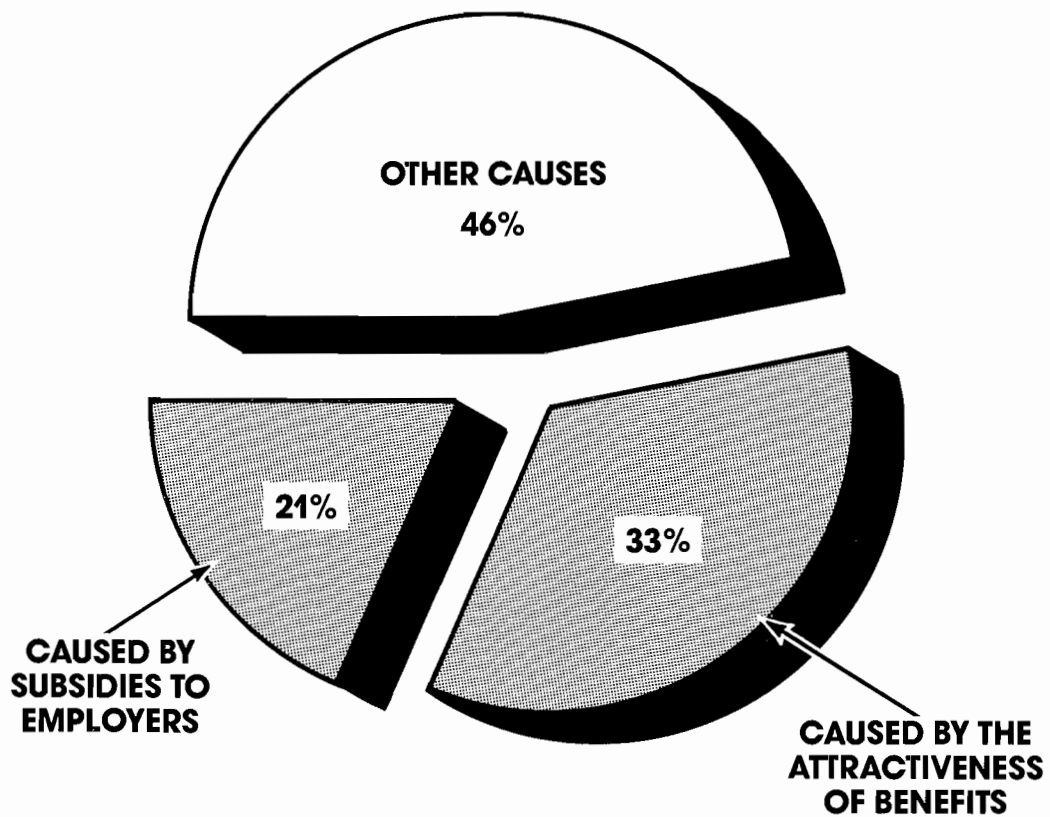
**Dallas, Texas 75247**

**(214) 951-0306**

# **PERCENT OF UNEMPLOYMENT CAUSED BY THE UNEMPLOYMENT COMPENSATION SYSTEM**

**(ADULT MALES)**

**1977-1981**



## EXECUTIVE SUMMARY

The Unemployment Compensation system encourages employers to lay off their employees and discourages the unemployed from finding new jobs. During the late 1970s and early 1980s,

- From one-third to one-half of all unemployment among adult male workers was caused by the Unemployment Compensation system.
- As much as 33 percent of adult male unemployment was caused by the attractiveness of benefits offered to unemployed workers.
- About 21 percent of unemployment occurred because the Unemployment Compensation system encourages employers to lay off their employees.

Even though there has been a reduction in available benefits during the 1980s, the system is still overly generous. In theory, the system is supposed to provide benefits only to people who lose a job through no fault of their own and who are able and willing to work. Yet,

- In many states, the unemployed can draw Unemployment Compensation benefits even though they also are receiving retirement pensions.
- In 42 states the unemployed can draw Unemployment Compensation benefits even though they are receiving Workers Compensation benefits (presumably because they are unable to work).
- In some states the unemployed can receive reduced benefits even if they quit their jobs, and even if they refuse offers of suitable work.
- In a majority of states, the unemployed can receive full benefits even if they also are receiving severance pay and experience no loss of income as a result of a job termination.

Because the system is incredibly complex, errors in the payment of benefits are common. On the average,

- More than one out of every four Unemployment Compensation benefit checks is for the wrong amount.
- About 16 percent of all benefit payments constitutes an overpayment -- money to which the recipient was not entitled.

Even though the U.S. economy is a dynamic economy which requires job switching, job relocation and training for new job skills, the Unemployment Compensation system is location-specific and job-specific. Job training and the development of new skills are discouraged and penalized.

The system can not be made to work through patchwork reform. What is required is privatization -- the creation of a private system in which workers and employers contribute funds to private accounts which workers manage and control. Money in these accounts could be used for job training, relocation costs, classes for upgrading skills, starting a new business, or income replacement during periods of unemployment.

## INTRODUCTION

At the time of its inception, the Unemployment Compensation system was designed to provide temporary income replacement for workers who (1) had previous work experience, (2) became unemployed through no fault of their own, and (3) were willing and able to work.

In the early part of the 20th century there were numerous experiments with private unemployment insurance on the part of employers, unions, and private insurance companies.<sup>1</sup> Some state governments adopted public unemployment insurance systems. The Social Security Act of 1935 set up a federal "insurance" system that copied these private and public sector plans in several ways. "Premiums" for covered workers were paid in the form of a payroll tax. Expected benefits were related to the employees' wages. And, premiums charged varied according to the experience of particular companies -- employers with high turnover rates were expected to pay more into the system as a consequence of the greater risk of providing insurance to their employees.

Today, 53 years later, the Unemployment Compensation system has been enlarged to encompass programs and payments never envisioned by the creators of the original system. Specifically,

- Far from providing temporary relief while the unemployed search for new jobs, the system today systematically rewards unemployment and discourages the search for productive work.
- Far from providing insurance against adverse events over which employers and employees have no control, the system actually encourages employers to lay off workers and subsidizes these layoff decisions.
- Rather than facilitating the employment needs of a changing, dynamic economy, the system discourages both retraining for new job tasks and relocation from job-losing to job-creating areas of the economy.
- The system has been encumbered by layer after layer of burdensome and complex regulations -- to the point where even those who administer the system often do not understand the rules they are administering.
- Partly as a result of the system's byzantine complexity, waste, inefficiency and even fraud are rampant -- with billions of dollars in overpayments made each year to individuals who are not eligible to receive those benefits.
- The system has strayed so far from the original principles of insurance, that only a tangential relationship exists between the risk of coverage and the premiums charged -- creating numerous opportunities for abuse and manipulation of the system by employers and employees alike.

---

<sup>1</sup>Daniel Nelson, *Unemployment Insurance: The American Experience, 1915-1935*, (Madison, Wisconsin: University of Wisconsin Press, 1969), pp. 28-29.

- The system has been repeatedly shaped, molded and manipulated by politicians at the federal and state level to the point where it increasingly serves political objectives quite different from the purposes for which it was created.

The defects of the Unemployment Compensation system are not accidental blemishes that can be reformed away by well-intentioned legislation. Instead, they are the natural and inevitable consequences of giving politicians control over an insurance scheme that is by nature highly political and emotionally sensitive.

Genuine reform means wholesale privatization. This means taking unemployment insurance out of the hands of politicians and placing it under the control of the people the system supposedly protects and benefits.

## SUBSIDIZING UNEMPLOYMENT

Economists have long known that if you want to encourage an activity, you subsidize it; if you want to discourage an activity, you tax it. In the United States, we tax employment and we subsidize unemployment. Moreover, until recent years, both the taxes and the benefits have grown continually throughout the post-World War II period. As a consequence, we have experienced a steady increase in the average U.S. unemployment rate, extrapolating from the normal employment effects of the business cycle.

### Paying People Not to Work

The Unemployment Compensation system encourages unemployment in numerous ways. The system encourages job terminations; it encourages people to remain unemployed for longer periods of time; it encourages more frequent spells of unemployment; it discourages people from seeking new jobs; and it encourages people to misrepresent their job search efforts in order to get around the rules and qualify for benefit checks.<sup>2</sup>

---

<sup>2</sup>Ronald Ehrenberg and Ronald Oaxaca, "Unemployment Insurance, Duration of Unemployment and Subsequent Wage Gain," *American Economic Review*, Vol. 66, December, 1986; Paul Burgess and Jerry L. Kingston, "UC Benefit Effects on Compensated Unemployment," *Industrial Relations*, Vol. 20, Fall, 1981; Jerry L. Kingston and Paul L. Burgess, "How Do UC Benefits Affect the Benefit Utilization Rate?," *Industrial Relations*, Vol. 16, February, 1977; John M. Barron and Wesley Mellow, "Search Effort in the Labor Market," *Journal of Human Resources*, Vol. 14, Summer 1979; Mathew Black and Timothy Carr, "An Analysis of Nonsearch," *Unemployment Compensation: Studies and Research*, Vol. 2, (Washington, D.C.: National Commission on Unemployment Compensation, 1980); and Robert D. St. Louis, Paul L. Burgess and Jerry L. Kingston, "Reported vs. Actual Job Search by Unemployment Insurance Claimants," *The Journal of Human Resources*, Vol. 21, Winter, 1986.

**TABLE I**  
**NET INCOME LOSS TO A MASSACHUSETTS FAMILY**  
**IF THE HUSBAND BECOMES UNEMPLOYED**  
**(1973)**

<b>Loss of Gross Wage</b>		<b>\$1,000</b>
- Federal Income Tax	<b>\$162</b>	
- Social Security Tax	<b>56</b>	
- State Income Tax	<b><u>50</u></b>	
		<b>(268)</b>
<b>Unemployment Compensation Benefits:</b>		
Basic Benefit	<b>500</b>	
Dependent's Allowance	<b><u>104</u></b>	
		<b><u>(604)</u></b>
<b>Decrease in Net Income</b>		<b>\$128</b>
<b>Income Loss as a Percent of Gross Wage</b>		<b>12.8%</b>

<sup>1</sup>The couple has two dependent children. The wife's wage is 70% of her husband's wage.

Source: Martin Feldstein, "Unemployment Compensation: Adverse Incentives and Distributional Anomalies," *National Tax Journal*, Vol. 27, No. 2, p. 233.

How serious are these perverse incentives? During the 1970s, the availability and generosity of Unemployment Benefits reached levels that alarmed economists concerned about rising unemployment rates. Not only were benefits generous and fairly easy to obtain, they also were not subject to income taxes. This meant that some families could actually experience an increase in their disposable income if one family member became unemployed. As Tables I and II show,

- In some states, a working couple could replace more than 80 percent of their lost income through Unemployment Compensation and reduced taxes if the husband lost his job.

- If the wife lost her job, the couple could replace more than 100 percent of their lost income.
- For the U.S. as a whole, a representative male worker could expect to recoup more than 60 percent of his lost income during the 1970s.
- A representative female worker could expect to recoup more than 80 percent of her lost income.

**TABLE II**  
**REPLACEMENT OF TAKE-HOME PAY**  
**UNDER UNEMPLOYMENT COMPENSATION**  
**(1973)**

<b>Massachusetts Male with a Working Wife and Two Dependent Children</b>	<b>83%</b>
<b>Massachusetts Female with a Working Husband and Two Dependent Children</b>	<b>88%</b>
<b>Massachusetts Female with a Working Husband and Three Dependent Children</b>	<b>105%</b>
<b>Representative U.S. Male Worker</b>	<b>60% +</b>
<b>Representative U.S. Female Worker</b>	<b>80% +</b>

Source: Martin Feldstein, "Unemployment Compensation: Adverse Incentives and Distributional Anomalies," *National Tax Journal*, Vol. 27, No. 2, pp. 295-306.

So generous were unemployment benefits in the 1970s that some collective bargaining agreements had "inverse seniority" provisions under which the most senior workers were laid off first.<sup>3</sup> This suggests that some labor unions regarded temporary layoffs with Unemployment Compensation benefits as equivalent to a paid vacation. Overall, studies in the 1970s indicated that workers receiving Unemployment Compensation benefits remained unemployed from 16 to 31 percent longer simply because of the availability of benefits.<sup>4</sup>

<sup>3</sup>Don Bellante and Mark Jackson, *Labor Economics*, (New York: McGraw-Hill, 1979), p. 275.

<sup>4</sup>See, for example, S.T. Marston, "The Impact of Unemployment Insurance on Job Search," *Brookings Papers on Economic Activity*, Vol. 1, 1975, pp. 13-48. Cited in Bellante and Jackson, *Labor Economics*, p. 275.

## **The Effect Of Recent Reforms**

In the 1980s, several developments have lowered the availability and magnitude of Unemployment Compensation benefits. The results have been predictable. Unemployed workers are now finding new jobs more quickly.

**Taxing Unemployment Benefits.** In 1979, the federal government began taxing unemployment benefits for families with annual incomes in excess of \$18,000. Even though the tax only applied to unemployed families with the least financial need, the effects of the change were notable.<sup>5</sup>

- For families whose benefits were subject to the federal income tax, the average length of unemployment dropped from 11 weeks to 8 1/2 weeks.
- About half of this drop was the direct result of a reduction in after-tax benefits.

Based on the results of this experience, it appears that relatively small changes in average weekly benefits can cause substantial changes in behavior among the unemployed. On the average,

- A \$20 increase in weekly Unemployment Compensation benefits increased the average length of unemployment by about one week.
- A \$20 decrease in weekly benefits decreased the average length of unemployment by about one week.

Partly as a result of the behavioral response to the change in the tax base in 1979, Congress extended the tax on Unemployment Compensation benefits through the Tax Reform Act of 1986. As of January 1, 1988, all Unemployment Compensation benefits are now taxed as ordinary income.

**Tightening Eligibility Requirements.** Under the Unemployment Compensation system, regular benefits are available for about 26 weeks. During periods of high unemployment, extended benefits are available for about 13 more weeks, and federal supplemental benefits (of varying duration) have been provided for up to 26 additional weeks. The availability of extended and supplemental benefits varies from state to state, but are constrained by various federal regulations.

In 1981, changes in the federal law led to substantial cutbacks in extended benefits and abolished supplemental benefits. In addition, the federal government started charging the states interest on loans made to insolvent state unemployment funds.<sup>6</sup> These changes appear to have led states to make substantial cutbacks in benefits. As a consequence, the availability of regular and extended benefits has declined dramatically in recent years.

One way to gauge the impact of these changes is to compare the experience of the U.S. with that of Canada. Prior to 1982, unemployment rates in the U.S. and

---

<sup>5</sup>Gary Solon, "Work Incentive Effects of Taxing Unemployment Benefits," *Econometrica*, Vol. 53, No. 2, March, 1985, pp. 295-306.

<sup>6</sup>P.L. 97-35 Omnibus Reconciliation Act of 1981, Section 2407.



Canada were very similar. Moreover, throughout the 1980s, the Canadian economy grew at a faster rate than the U.S. economy did. Yet the availability of unemployment benefits in Canada has barely changed in recent years, while the availability of benefits in the U.S. has decreased. Partly as a result of this difference, unemployment rates in the two countries have now sharply diverged:<sup>7</sup>

- Between 1960 and 1980, the average unemployment rates in the U.S. and Canada were 5.6 percent and 5.8 percent respectively; and in 1981, the rate in both countries stood at 7.6 percent.
- Between 1982 and 1987, however, the average unemployment rate in the U.S. was 7.9 percent, while in Canada unemployment rose to 10.5 percent.
- As of January, 1988, the U.S. unemployment rate was 5.8 percent, while the Canadian rate was 8.1 percent.

At the time of this writing, the U.S. unemployment rate stands at its lowest level since the early 1960s. One reason for the decrease is that the reforms described above have made unemployment less attractive. But there are other contributing factors as well. Welfare reforms in the early 1980s also made unemployment less attractive, while tax reform has increased the economic incentive to find a job.<sup>8</sup>

### **How Generous Are Unemployment Compensation Benefits Today?**

Even after the reforms of the 1980s, the Unemployment Compensation system today is far from stingy. In most states, workers can recoup 50 percent or more of their lost income, and they can obtain benefits under circumstances quite different from those envisioned by the creators of the system.

**Average Weekly Benefits.** Although the formulas for calculating Unemployment Compensation benefits differ considerably from state to state, most adopt a formula under which unemployed workers can obtain 50 percent of their previous wage -- subject to a maximum benefit amount. In some states, benefits are even more generous. For example,<sup>9</sup>

- In Colorado, the unemployed can collect as much as 60 percent of their prior weekly wage income.

---

<sup>7</sup>Statistics compiled by Vivek Moorthy, Federal Reserve Bank of San Francisco, and reported in Moorthy, "Jobless Benefits: A Tale of Two Countries," *The Wall Street Journal*, March 22, 1988.

<sup>8</sup>As of 1984, the Reagan tax cuts had added as many as 3.9 million people to the labor force. Cuts in benefit programs added as many as 950,000 people to the labor force. The combined effect of these "supply-side" policies was to create as many as 4.5 million new jobs. See David R. Henderson, "Analyzing the Reagan Record," NCPA Policy Report No. 114, October, 1984, pp. 10-11.

<sup>9</sup>National Foundation for Unemployment Compensation and Workers Compensation, *Highlights of State Unemployment Compensation Laws*, Washington, D.C., January, 1988, pp. 46-48.

- In New Jersey and Rhode Island, the unemployed collect 60 percent of their previous wage plus an allowance for their dependents.
- In Michigan, the replacement rate is 70 percent of the previous after-tax weekly wage.

**Unemployment Compensation and Workers Compensation.** In theory, Unemployment Compensation benefits are supposed to be made available to unemployed workers who are able to work, while Workers Compensation benefits are supposed to be made available to unemployed workers who are unable to work. Yet in many states, the unemployed are able to collect both types of benefits at the same time! For example,<sup>10</sup>

- Twenty-five states plus the District of Columbia, Puerto Rico and the Virgin Islands have no specific prohibition against the receipt of both Unemployment Compensation benefits and Workers Compensation benefits, although prohibitions may be made administratively in individual cases.
- In 17 other states, recipients of Workers Compensation benefits may qualify for reduced Unemployment Compensation benefits.
- Recipients of Workers Compensation benefits are specifically precluded from receiving Unemployment Compensation benefits in only eight states.

**Voluntarily Leaving Work Without Good Cause.** Under the original principles governing the Unemployment Compensation system, workers were supposed to qualify for benefits only if they lost a job through no fault of their own. Thus quitting a job without a "good cause" would make one ineligible for benefits. Yet many states have made modifications and exceptions to this rule. For example, in many states individuals are eligible for benefits if they quit work in order to relocate with a spouse who is searching for a new job. Other violations of this principle also are common:<sup>11</sup>

- In Colorado, a person who voluntarily quits a job without good cause is entitled to 16, rather than 24, weeks of benefits.
- In Indiana, the voluntarily unemployed are entitled to 75 percent of normal benefits.
- In Wisconsin, the voluntarily unemployed are entitled to 50 percent of normal benefits.

**Termination for Misconduct.** Like voluntarily quitting, being terminated for misconduct (e.g., violation of company rules, insubordination, unexcused absences, refusal to perform assigned work, etc.) also should disqualify a person from receiving benefits under the original theory. Yet,<sup>12</sup>

---

<sup>10</sup>*Ibid.*, pp. 59-61.

<sup>11</sup>*Ibid.*, pp. 62-64.

<sup>12</sup>*Ibid.*, pp. 65-68.

- In Maryland, a worker fired for misconduct would have normal benefits postponed for as few as four weeks; and in Vermont, benefits would be postponed for as few as six weeks.
- In New Jersey, benefits would be postponed for five weeks; and in Arkansas, the postponement would be for seven weeks.

**Pension and Other Retirement Income.** Under federal law, states are required to reduce (dollar for dollar) weekly Unemployment Compensation benefits by the amount of any retirement pension received -- probably on the theory that pensions are designed to provide income replacement for people when they quit working. Yet there are loopholes in this rule as well. For example,<sup>13</sup>

- Only four states reduce benefits, dollar for dollar, to offset pension income from any source.
- By contrast, almost all other states allow people to collect Unemployment Compensation benefits and retirement pensions from some source other than the terminating employer.
- In 24 states, it is possible to collect both Unemployment Compensation benefits and a retirement pension from the terminating employer.

**Refusal to Accept a New Job.** In theory, recipients of Unemployment Compensation benefits are required to search for a suitable job and to accept an offer of suitable employment if one is made. In practice, the word "suitable" has so many qualifications attached to it that it is relatively easy for people to avoid work if that is their preference. In general,<sup>14</sup>

- Recipients may refuse work if it is unrelated to their customary occupations.
- Recipients may refuse work if the wages are lower, the hours of work are longer, or if the place of employment is considerably farther from the recipient's home.
- Recipients may refuse work if it involves greater risk to their health and safety than their previous job.

---

<sup>13</sup>Technically, 24 states allow the UC recipients to collect retirement pensions from their "base period employer" provided they did not achieve pension eligibility or increase the size of their pension during the "base" period. A base period generally is the 12 month period prior to the receipt of benefits. *Ibid.*, pp. 59-62.

<sup>14</sup>Burgess and Kingson, *An Incentives Approach to Improving the Unemployment Compensation System*, p. 165. Note: In many states, the definition of suitable work typically becomes less stringent over time. For example, after 25 weeks of benefits, Florida considers a job suitable if it pays the minimum wage and if the wage is 120 percent or more of the recipient's weekly Unemployment Compensation benefits. Federal law requires that states disregard a recipient's prior experience, training and earnings in the case of extended benefits. See *Highlights of State Unemployment Compensation Laws*, pp. 68-70.

- Recipients may even refuse work if the wages, hours and working conditions are less favorable than those prevailing for similar jobs in the locality.

Even if a beneficiary does refuse suitable work, in many states nothing can be done about such behavior until the beneficiaries first have received a written warning that their job search behavior is deficient. Moreover, once a clear violation is established, in many states the penalties can be quite mild. For example,<sup>15</sup>

- In Alabama, California and Mississippi, a person who refuses suitable work may lose as little as one week of Unemployment Compensation benefits.
- In Maryland, such a person could lose as few as four weeks of benefits.
- In New Jersey, the person would lose only three weeks of benefits.

**Severance Pay.** At the time of a job termination, many employers give their employees severance pay or dismissal pay. The purpose of such payments is identical to the purpose of the Unemployment Compensation System -- to replace lost income during a period of temporary unemployment. Yet in most states, the unemployed can collect full benefits even if they are receiving severance pay and even if they have experienced no loss of income. Specifically,<sup>16</sup>

- In 27 states, the unemployed receive full benefits even though they are receiving severance pay.
- In 16 other states, the unemployed can receive both severance pay and reduced benefits.
- In only seven states are Unemployment Compensation benefits disallowed for severance or dismissal income.

### **Subsidizing Employer Layoffs**

Until recently, most economic research on the Unemployment Compensation system focused on ways in which the system encourages workers to extend the duration of unemployment because of the attractiveness of benefits. The newest research, however, has focused on the reasons for job terminations in the first place. The findings are that many layoffs occur because the Unemployment Compensation system encourages employers to lay off workers, and this may be a more important cause of overall unemployment than the attractiveness of benefits.

Under the original design of the Unemployment Compensation system, taxes paid by employers were to resemble insurance "premiums" and were supposed to reflect the costs the employer imposed on the system through employee terminations.

---

<sup>15</sup>*Highlights of State Unemployment Compensation Laws*, pp. 68-70.

<sup>16</sup>*Ibid.*, pp. 59-61

Taxes paid were to be accounted for through individual employer reserve accounts and benefits paid to former employees were to be deducted from the employer's account. In theory, if a firm had twice as many terminations as a similarly situated employer, the firm could expect to have twice as much in benefits charged against its reserve account, and would expect to pay twice as much in Unemployment Compensation taxes. A system that behaves in this way is said to practice perfect "experience rating."

Taxes based on experience rating serve an important economic function: They force employers to balance the cost of layoffs (realized in the form of higher payroll taxes) against the cost of continued employment. To the degree that taxes do not reflect employer experience, employers will not bear the full cost of their layoffs. They will be able to shift the cost of layoffs to other taxpayers. Failure to experience rate, then, subsidizes layoffs and creates more overall unemployment.<sup>17</sup>

Unfortunately, the Unemployment Compensation system has strayed far from its original design in this respect. In the first place, a significant percentage of benefits paid in all states are not charged against any employer's account. In the second place, all states establish a maximum tax rate. Once this maximum is reached, further layoffs have no effect upon employers, even if their reserve accounts become negative. Table III shows how serious the problem has become. For the six states studied,<sup>18</sup>

- In 1967, firms with negative balances accounted for only 9.4 percent of all employment, yet these firms were responsible for almost half of all Unemployment Compensation benefits.
- The average unemployment rate among firms with negative balances was more than five times the average unemployment rate for all firms.

By 1978, these differences had narrowed somewhat, as more and more firms reached the maximum tax rates. Even so, firms with negative balances that year continued to have a substantially disproportionate effect on the system. For the six states studied,<sup>19</sup>

- In 1978, firms with negative balances accounted for only about one-fifth of total employment, yet they generated more than half of all Unemployment Compensation benefits.
- The unemployment rate for firms with negative balances that year was more than 2 1/2 times the statewide average unemployment rate.

---

<sup>17</sup>It is important to realize that in the absence of an Unemployment Compensation system, firms and industries with high layoff rates would have to pay higher wages, or pay for private unemployment benefits, in order to attract workers from other firms and other industries.

<sup>18</sup>Robert H. Topel, "On Layoffs and Unemployment Insurance," *The American Economic Review*, Vol. 73, No. 4, September, 1983, Table 2, p. 544.

<sup>19</sup>*Ibid.*

**TABLE III**  
**SUBSIDIZING LAYOFFS:**  
**FIRMS WITH NEGATIVE U.C. BALANCES<sup>1</sup>**

<u>State</u>	<u>Proportion of Employment<sup>2</sup></u>	<u>Proportion of U.C. Benefits</u>
<b>California:</b>		
1967	14.2 %	51.8 %
1978	14.3 %	52.5 %
<b>Massachusetts:</b>		
1967	11.8 %	55.3 %
1978	13.1 %	46.0 %
<b>Michigan:</b>		
1967	3.6 %	34.8 %
1978	28.0 %	68.1 %
<b>New York:</b>		
1967	13.8 %	61.6 %
1978	28.4 %	72.7 %
<b>Ohio:</b>		
1967	4.4 %	34.2 %
1978	29.9 %	58.1 %
<b>Wisconsin:</b>		
1967	8.5 %	60.8 %
1978	14.4 %	26.9 %
<b>Unweighted Average:</b>		
1967	9.4 %	49.8 %
1978	21.4 %	54.1 %

<sup>1</sup>These are firms for which UC benefit charges exceed the total of all previous UC taxes paid. In most cases, these firms are paying the maximum UC tax.

<sup>2</sup>Measured as the total taxable wages paid by firms with negative account balances divided by the total taxable wages paid by all firms.

Source: Robert H. Topel, "On Layoffs and Unemployment Insurance," *The American Economic Review*, Vol. 73, No. 4, September, 1983, Table 2, p. 544.

The problem of failure to experience rate continued to worsen in the early 1980s. For example, a study of 12 states conducted by the Department of Labor found that the percentage of the benefits payments charged to employers with positive reserve balances fell from 51 percent of all benefits in 1970 to 36 percent in 1983.<sup>20</sup>

The failure of the Unemployment Compensation system to follow the principle of experience rating results in employers with a steady employment record subsidizing other employers who lay off workers periodically. Studies have found that, nationwide, agricultural and construction firms are heavily subsidized by firms engaged in retail trade, finance, insurance and real estate.<sup>21</sup> For example,<sup>22</sup>

- In the construction industry, firms that pay any cost as a result of layoffs can expect to pay only 43 cents in taxes for each dollar of benefits they generate, and almost half of all construction workers work for a firm that will pay no additional taxes as a result of a layoff.
- By contrast, in the banking industry, firms pay 77 cents in taxes for every dollar of benefits they generate and 7.9 percent of banking employees work for firms that are paying the maximum tax.

Failure to experience rate also raises the overall unemployment rate. As we shall see, one study estimates that the U.S. unemployment rate is 20 percent higher than it otherwise would be because of subsidies to employers caused by the failure to adequately experience rate.

### **Summary of the Effects of the Unemployment Compensation System on Unemployment**

Robert Topel, of the University of Chicago, has recently attempted to estimate the different ways in which the Unemployment Compensation system causes different types of unemployment. Using different techniques, Topel discovered that from one-third to one-half of all unemployment is caused by the Unemployment Compensation system. One of Topel's estimates is reproduced in Table IV. As the table shows,

- As much as 54 percent of all unemployment among adult male participants in the labor force is caused by the Unemployment Compensation system.
- About 33 percent of unemployment is caused by the attractiveness of benefits, and about 21 percent is caused by subsidies to employers who are inadequately experience rated.

---

<sup>20</sup>Burgess and Kingston, *An Incentive Approach to Improving the Unemployment Compensation System*, Table 2-2, p. 183.

<sup>21</sup>*Economic Report of the President*, (Washington D.C.: Council of Economic Advisors, 1988), p. 193.

<sup>22</sup>Robert H. Topel, "Unemployment and Unemployment Insurance," *Research in Labor Economics*, Vol. 7, 1985, Table 10, p. 118.

Another interesting discovery by Topel is the finding that the Unemployment Compensation system has its greatest impact on temporary layoffs -- workers who are re-hired by the firm that terminated them. What this means is that the Unemployment Compensation system is providing huge subsidies to employers and workers in markets where employment is seasonal or cyclical.

**TABLE IV**  
**PERCENT OF UNEMPLOYMENT**  
**CAUSED BY THE UNEMPLOYMENT COMPENSATION SYSTEM<sup>1</sup>**  
**(Adult Males)**  
**1977-1981**

<u>Type of Unemployment</u>	<u>Percent of Unemployment Caused by Attractiveness of Benefits</u>	<u>Percent of Unemployment Caused by Subsidy To Employers</u>	<u>Total Percent of Unemployment Caused by the U.C. System</u>
Temporary Layoffs	23%	15%	38%
Permanent Layoffs	6%	6%	12%
Quits	<u>4%</u>	<u>-</u>	<u>4%</u>
Total	33%	21%	54%

<sup>1</sup>Unemployment is for adult, male, full-time participants in the labor market. These estimates are based on a maximum likelihood estimating model. Somewhat lower estimates for total unemployment were obtained using a linear-probability model. For example, using the second model, the Unemployment Compensation system is responsible for 31 percent of total unemployment.

Source: Robert H. Topel, "Unemployment and Unemployment Insurance," Research in Labor Economics, Vol. 7, 1985, Table 14, p. 129.

Note: These figures should be viewed as rough estimates only. They are based on measurements of the effects of small changes in benefit levels. These measurements were then extrapolated to make a global estimate of the effects of the presence or absence of the UC system as a whole. Despite this fact, these are the best estimates currently available. Note also that these estimates were made before UC benefits became subject to income taxes.



## TAXING EMPLOYMENT

At the same time that the Unemployment Compensation system encourages unemployment through its benefit payments, the system also closes off job opportunities through the taxes it imposes on work. Unemployment Compensation taxes for many employers are quite high; their greatest burden falls on workers with the lowest incomes; and they discourage job creation in the labor market.

**Unemployment Compensation Taxes.** As noted above, Unemployment Compensation payroll tax rates vary from state to state and from employer to employer. For some employers, the tax burden is quite heavy:<sup>23</sup>

- In ten states, employers face payroll taxes as high as nine percent or more of covered wages.
- In Michigan and Tennessee, the Unemployment Compensation payroll tax can reach as high as 10 percent of covered wages.

Although federal law requires that the tax be imposed on the first \$7,000 of wages, most states exceed that amount. For example,<sup>24</sup>

- In 16 states, Unemployment Compensation tax rates apply to at least the first \$10,000 of wages.
- In Idaho, the tax is applied to the first \$16,200 of wages, and in Alaska the taxable wage reaches \$21,100.

**Regressivity of U.C. Taxes.** Unemployment Compensation taxes are nominally paid by employers and do not show up as part of the employee's gross wage. Yet a widely accepted principle of labor economics is that the burden of the payroll tax falls on workers, not employers. This is because employers will not hire workers unless the value of what they produce is at least equal to their wages plus fringe benefits plus payroll taxes. From a financial point of view, how the total compensation package is divided should make little difference to the employer. In other words, a payroll tax is simply one of the costs of labor -- a sum that would otherwise have been spent on wages or fringe benefits.

Because of the cap on taxable wages, however, Unemployment Compensation taxes are highly regressive, imposing their heaviest burden on low-income employees. For example,<sup>25</sup>

- A worker earning \$7,000 in Tennessee can face an Unemployment Compensation tax burden equal to 10 percent of gross salary.
- A co-worker earning \$14,000, however, faces an Unemployment Compensation tax burden equal to only five percent of gross salary.

---

<sup>23</sup>*Highlights of State Unemployment Compensation Laws*, Table 13, p. 35.

<sup>24</sup>*Ibid.*

<sup>25</sup>*Ibid.*

- A co-worker earning \$70,000 faces an Unemployment Compensation tax burden equal to only one percent of salary.

This regressivity in the tax burden might be justified if there were a close relationship between taxes and expected benefits. Yet as noted above, there is very little relationship between taxes paid and benefits received in the system as a whole.

When Unemployment Compensation taxes are combined with Social Security payroll taxes, it is amazing to consider how high the marginal tax rates on low-income workers can be:<sup>26</sup>

- In at least 10 states, low-income workers face combined Social Security and Unemployment Compensation tax rates that can reach as high as 24 percent of salary.
- Yet the vast majority of these workers earn so little that they pay virtually no income taxes.

**Eliminating Jobs.** To date, there has been no rigorous attempt to estimate the effect of Unemployment Compensation taxes on job opportunities. Yet the job-destroying effects of these taxes very probably are quite high. A recent study of the Social Security payroll tax, for example, estimated that the one percentage point increase in the Social Security payroll tax between 1988 and 1990 will have the effect of eliminating more than one-half million jobs.<sup>27</sup>

## DISCOURAGING INDIVIDUAL GROWTH AND CHANGE IN A DYNAMIC LABOR MARKET

The American economy is a dynamic and changing economy in which jobs are being continually created and destroyed:<sup>28</sup>

- On the average, communities across the country lose about 10 percent of their jobs every year.
- Over a five-year period about half of all the initial jobs will be lost.

In a growing economy, more new jobs will be created than the number of jobs that are lost. But the implications for change are staggering:

- At the end of any five-year period, one out of every two jobs in existence will be lost by the end of the period.

---

<sup>26</sup>*Ibid.*

<sup>27</sup>Aldona Robbins and Gary Robbins, "Effects of the 1988 and 1990 Social Security Tax Increases," Institute for Research on the Economics of Taxation, No. 39, February 3, 1988.

<sup>28</sup>Analysis of David Birch (MIT), reported in The National Commission on Jobs and Small Business, *Making America Work Again: Jobs, Small Business, and the International Challenge*, (Washington, D.C.: The National Commission on Jobs and Small Business, 1987), p. 13.

- At the beginning of any five-year period, one out of every two jobs in existence is a new job.

Given the rapidity with which jobs are being created and destroyed, small wonder that there is a great deal of job switching in the economy and that most workers spend a relatively small proportion of their career in any one job. For example,<sup>29</sup>

- On the average, a male worker in the U.S. economy has been working for his current employer for only 6.9 years.
- A female worker in the U.S. economy has been working for her employer for only 4.8 years.

An important feature of a dynamic, changing economy is that the efficient use of labor resources requires that workers be willing to move from one location to another and to retrain for new vocations as job opportunities change. Yet one of the worst features of the Unemployment Compensation system is that it is job-specific and location-specific -- resisting the very changes that workers need and require. Specifically, the definition of "suitable work" (used to determine eligibility for benefits) is based on a job the worker is already trained for, and the availability of a new job is based solely on the labor market in which the worker resides -- not the national labor market.

Shockingly, almost all states have a general prohibition against going to school or enrolling in job-training programs while at the same time receiving Unemployment Compensation benefits. When dispensations are given to allow education and training, the beneficiary almost always is required to be continually available for work. Thus, when a job does become available, the beneficiary is required to quit school and take the job. This practice discourages beneficiaries from making an investment in job training and penalizes those who do make such investments.

## WASTE, INEFFICIENCY AND FRAUD

Allegations of "fraud," "abuse," "waste" and "improper management of funds" have plagued the Unemployment Compensation system almost since its inception.<sup>30</sup>

- In 1946 the *Baltimore Sun* won a Pulitzer Prize for a series of articles on the program's abuses.
- In the 1960s, a series of similar articles also appeared in *Reader's Digest*, *Harper's* and *Atlantic Monthly*.

The essence of these exposes was that people were receiving benefits they were not entitled to, that many people claiming to be searching for new jobs were not really

---

<sup>29</sup>Estimates of the Bureau of Labor Statistics, U.S. Department of Labor, March 1, 1984.

<sup>30</sup>Paul L. Burgess and Jerry L. Kingston, *An Incentive Approach to Improving the Unemployment Compensation System*, (Washington, D.C.: National Chamber Foundation, 1987), pp. 17-19.

doing so, and that when program administrators discovered overpayments (whether because of fraud or other reasons) they made insufficient effort to recover the money.

Articles in the popular press were based on anecdotal evidence, however. They were invariably at odds with the official numbers published by the Department of Labor showing that the error rates in payments were quite low.

It was not until 1979 that the National Commission on Unemployment Compensation commissioned a series of independent studies on error rates in the system. Chosen to direct the studies were Paul Burgess and Jerry Kingston, both professors of economics at Arizona State University. Both specialize in the field of labor economics and had previously conducted extensive research on the Unemployment Compensation system. It is noteworthy that there was considerable political pressure exerted to prevent these studies from being conducted. And, once completed there was considerable political pressure to keep the results from being published. It's not hard to understand why. As Table V shows,

- A study of five states discovered that, on the average, one out of every five weekly unemployment checks represented an overpayment of benefits.
- In the state of New Jersey, 38 percent of all checks were overpayments.
- In terms of dollar amounts, 13.1 percent of all money spent in the five states represented an overpayment of benefits, and in New Jersey that figure reached almost one out of every four dollars of benefit payments.

**TABLE V**  
**OVERPAYMENTS OF UNEMPLOYMENT COMPENSATION**  
**BENEFITS**  
**(1981-1982)**

<u>State</u>	<u>Percentage of Total Checks</u>	<u>Percentage of Total Dollars Paid</u>
Illinois	16.0 %	11.9 %
Kansas	14.1 %	12.9 %
Louisiana	10.5 %	7.3 %
New Jersey	38.2 %	24.3 %
Washington	20.0 %	9.3 %
Five-State Average	19.8 %	13.1 %

Source: Paul L. Burgess, Jerry L. Kingston and Robert D. St. Louis, *The Development of an Operational System for Detecting Unemployment Insurance Payment Errors Through Random Audits: The Results of Five Statewide Pilot Tests*, (Washington, D.C.: U. S. Department of Labor, Employment and Training Administration, Unemployment Insurance Service, 1982), p. 47. Reprinted in Paul L. Burgess and Jerry L. Kingston, *An Incentives Approach to Improving the Unemployment Compensation System*, (Washington, D.C.: National Chamber Foundation, 1987), Table 2-3, p. 31.

The Unemployment Compensation system also underpays benefits -- i.e., pays people less than what they are entitled to receive. Although the amounts of money are usually small, the frequency of this practice is high. For example, in the five-state study described above, 6.3 percent of all checks represented an underpayment, with a high of 13.9 percent in New Jersey.

When overpayments are added to underpayments, it is amazing to consider how many Unemployment Compensation benefit checks are for the wrong amount. As Table VI shows,

- For the five states studied, on the average, one out of every four weekly benefit checks was for the wrong amount.
- In the state of Washington, almost one-third of all benefit checks were for the wrong amount.
- In the state of New Jersey, more than one-half of all benefit checks were for the wrong amount.

**TABLE VI**  
**INCORRECT PAYMENTS OF**  
**UNEMPLOYMENT COMPENSATION BENEFITS**  
**1981-1982**

<u>State</u>	<u>Percent of Total Checks</u>
Illinois	19.1 %
Kansas	15.0 %
Louisiana	12.2 %
New Jersey	52.1 %
Washington	31.7 %
Five-State Average	26.1 %

Source: Paul L. Burgess, Jerry L. Kingston and Robert D. St. Louis, *The Development of an Operational System for Detecting Unemployment Insurance Payment Errors Through Random Audits: The Results of Five Statewide Pilot Tests*, (Washington, D.C.: U.S. Department of Labor, Employment and Training Administration, Unemployment Insurance Service, 1982), p. 47. Reprinted in Paul L. Burgess and Jerry L. Kingston, *An Incentives Approach to Improving the Unemployment Compensation System*, (Washington, D.C.: National Chamber Foundation, 1987), Table 2-3, p. 31 and Appendix Table 1, p. 37.

A subsequent study by the same research team was expanded to cover 46 states and was completed in 1985. Most of the findings of this study have still not been made public by the Department of Labor -- apparently under pressure to suppress the report by state governments. In 1987, however, the Department did release the following:<sup>31</sup>

- For the 46 states covered by the study, 15.6 percent of all money spent represented an overpayment of benefits.
- Given the Department of Labor's budget projections, this means that over the next four years we can expect \$9.6 billion in overpayments through the Unemployment Compensation system.

### THE IMPOSSIBILITY OF ADMINISTERING THE SYSTEM

One reason why there are so many errors in payments of Unemployment Compensation benefits is that the laws, rules and regulations governing the system are so incredibly complex that even the system's administrators do not claim to fully understand them. Asking whether or not a particular individual is entitled to a benefit check is comparable to asking whether a particular deduction is allowable under the Internal Revenue Service Code. For claimants to know for certain whether they qualify for benefits would probably require a course in labor law. For administrators to know with certainty whether a particular claim is valid would probably require more time and effort than the value of the claim being paid.

**Federal Laws.** In the early years of the operation of the program, there were very few changes in the federal laws governing it. In recent years, however, there has been a virtual explosion of changes in federal law. For example, the Department of Labor has estimated that,<sup>32</sup>

- From January, 1981 to February, 1985 there were 77 changes in federal laws governing the program.
- These changes in federal law resulted in about 2,000 changes in laws at the state level.

**State Laws.** Within the general parameters determined by federal law, state governments are free to impose their own rules and regulations governing eligibility, benefit levels, and enforcement procedures. As Table VII shows, the combined effect of federal and state guidelines has created a bureaucratic monstrosity. For example,<sup>33</sup>

---

<sup>31</sup>*Ibid.*, pp. 54-55.

<sup>32</sup>Patrick J. O'Keefe, "Testimony Before the Subcommittee on Public Assistance and Unemployment Compensation, Committee on Ways and Means, U.S. House of Representatives," February 20, 1985, Washington, D.C.: U. S.. Department of Labor, Employment and Training Administration, p. 4. Cited in Burgess and Kingston, *An Incentives Approach to Improving the Unemployment Compensation System*, p. 58.

<sup>33</sup>*Ibid.*, p. 59

- In the state of Arizona there are five major eligibility categories that must be addressed in determining whether a claimant qualifies for benefits.
- In the Arizona manual of Benefit Policy Rules, these five categories are broken down into 79 sections and 147 subsections.
- If Arizona claimants want to determine whether or not they qualify for benefits, they must plough through 148 pages of legalese -- a task that is probably impossible without the assistance of a labor lawyer.

**TABLE VII**  
**COMPLEXITY OF THE SYSTEM**

**Selected Portions of Written Guidelines for Determining Eligibility  
for Unemployment Compensation in Arizona.**

<b><u>Category</u></b>	<b><u>Number of Major Sections</u></b>	<b><u>Number of Subsections</u></b>	<b><u>Number of Text Pages</u></b>
<b>Voluntary Leaving</b>	<b>7</b>	<b>31</b>	<b>45</b>
<b>Misconduct</b>	<b>19</b>	<b>44</b>	<b>29</b>
<b>Able/Available</b>	<b>25</b>	<b>30</b>	<b>38</b>
<b>Refusal of Work</b>	<b>17</b>	<b>24</b>	<b>20</b>
<b>Labor Disputes</b>	<b>11</b>	<b>18</b>	<b>16</b>
<b>Total</b>	<b>79</b>	<b>147</b>	<b>148</b>

Source: Paul L. Burgess and Jerry L. Kingston, *An Incentives Approach to the Unemployment Compensation System*, (Washington, D.C.: National Chamber Foundation, 1987), Table 3-1, p. 55.

**Costs of Administration.** Owing to the complexity of the rules and regulations, a common perception among those who administer the system is that a way can be found to pay or deny almost any claim. This perception is understandable. In the independent audits described above, investigators discovered that it was extraordinarily time consuming and expensive to go through all of the steps necessary to determine whether a claim was valid. Specifically:<sup>34</sup>

---

<sup>34</sup>*Ibid.*, p. 59

- Investigators found that it took from eight to 13 hours of direct case time to determine whether one claimant was eligible for one week of unemployment compensation.
- In many cases, this means that the cost of determining the eligibility of a claimant was greater than the value of the Unemployment Compensation check.
- Were agency personnel to go through the same rigorous procedures as the independent auditors, the Unemployment Compensation bureaucracy would have to be increased as much as 50 times its current size in order to administer the program.

**Some Consequences of Complexity.** As a result of the burdensome and complex regulatory environment in which the Unemployment Compensation system operates, the system generates considerable social costs:

1. Efficient administration of the Unemployment Compensation system -- one which maintained a very low error-in-payment rate -- would require huge increases in the program budget.
2. Because the politicians who govern the system seem unwilling either to simplify the rules or greatly expand the budget, high error-in-payment rates are a permanent and enduring feature of the system.
3. Because of the complexity and ambiguity of the rules, and because of the limited size of the administration budget, case workers have enormous discretion to accept or deny claims based on their personal preferences and predispositions.
4. Unfairness and inequities are inevitable -- with identically situated claimants receiving different treatment under the system.
5. Because of all of the above, incentives for abuse of the system are rampant.

## **PERVERSE INCENTIVES**

The Unemployment Compensation system from top to bottom is replete with perverse incentives. Beneficiaries and potential beneficiaries, employers, the Unemployment Compensation bureaucracy -- all find that it is in their economic self-interest to abuse the system by acting in ways that cost taxpayers money and make the unemployment rate higher than it could or should be. What follows is a brief summary of some of these perverse incentives.

**Perverse Incentives: Beneficiaries.** As an insurance system, Unemployment Compensation pays claims for adverse contingencies. Yet the set of "events" which establish whether a claim is valid primarily depend not on an objective set of facts, but on the recipient's state of mind. Was an employee really terminated through no fault of his own? Is he really making a good faith effort to search for new employment? Has he avoided offers of suitable employment? Without the capabilities of a mind reader, these questions can prove almost impossible to answer. As a result,



people who want to be unemployed in order to receive benefits find they have numerous opportunities to do so.

Take the "work search" test, for example. Almost any of us could manage to conduct a job interview in a way that would insure that an offer of employment was not made. Very little thought or creativity would be required. Small wonder, then, that in 1983, out of every 10,000 claims for weekly Unemployment Compensation benefits, only two were denied because of a refusal of suitable work.<sup>35</sup>

In addition to the difficulties surrounding a beneficiary's state of mind, there also is the problem of more objective violations of the law, such as earning unreported income while at the same time drawing Unemployment Compensation benefits. For the U.S. economy as a whole, estimates of the size of the "underground" economy are huge. Studies suggest that the underground economy produces between 6.0 and 14 percent of officially reported gross national product.<sup>36</sup>

Violations due to unreported earnings are rarely detected. One exception to this generalization is a special study of people who were participating in the federal government's Income Maintenance Experiments in the 1970s. One study of these experiments found that,<sup>37</sup>

- In Seattle and Denver between 7.6 and 13.6 percent of all weekly Unemployment Compensation checks went to persons who had unreported income.
- Moreover, among those who failed to report their earnings, the size of the unreported earnings were quite large.

Even for violations that are easier to detect, a simple calculation of the expected costs and benefits of cheating will convince a great many beneficiaries that cheating pays. In the first place, the probability of getting caught is quite low. In the second place, even when a violator is caught, the penalties are usually quite nominal. Consider, for example, the probability of being detected for a violation of the rules. A study of six metropolitan areas discovered that,<sup>38</sup>

---

<sup>35</sup>Burgess and Kingston, *An Incentive Approach to Improving the Unemployment Compensation System*, p. 164.

<sup>36</sup>See Vito Tanzi, "The Underground Economy in the United States: 1930-1980," *International Monetary Fund Staff Papers*, No. 30, June, 1983, p. 302; and Richard Porter and Amanda Bayer, "A Monetary Perspective on Underground Activity in the United States," *Federal Reserve Bulletin*, No. 70, March, 1984, pp. 178-179.

<sup>37</sup>Black and Carr, "An Analysis of Nonsearch," p. 554. Cited in Burgess and Kingston, *An Incentives Approach to Improving the Unemployment Compensation System*, p. 163.

<sup>38</sup>Jerry L. Kingston and Paul L. Burgess, *Unemployment Insurance Overpayments and Improper Payments in Six Major Metropolitan Areas*, (Washington D.C.: National Commission on Unemployment Compensation, 1981), p. 46. Cited in Burgess and Kingston, *An Incentives Approach to Improving the Unemployment Compensation System*, Table 2-2, p. 27.

- The actual number of violations was at least four times the number of violations detected through normal, routine procedures in five of the six cities.
- In one city the number of actual violations was 42 times the number of detected violations.

Once a violation is detected, the perpetrator usually faces no greater penalty than simply repaying the benefit amount that was erroneously paid. If convicted of fraud, a beneficiary could face fine or imprisonment. However, the difficulties of obtaining such convictions usually ensure that they are not pursued.

**Perverse Incentives: Employers.** As noted above, firms which lay off workers frequently are not merely offering prospective employees a wage. They are offering a wage (during periods of expected employment) plus Unemployment Compensation (during periods of expected unemployment). The wage is paid by the employer. But the unemployment benefits are paid largely by others. The Unemployment Compensation system, then, subsidizes the expected compensation package and encourages the employer to pursue a policy of frequent layoffs. In the absence of Unemployment Compensation, the employer would have fewer layoffs and there would be less unemployment.

In a similar way, the Unemployment Compensation system encourages permanent plant closings and extends the length of temporary plant closings. For example, if a firm closes a plant in one state and opens a plant in another state, the firm immediately ceases paying Unemployment Compensation taxes in the state with the closed plant, and thus pays none of the costs of the layoff. Moreover, taxes in the state where the new plant is opened are totally unrelated to the employer's layoff experience in the state in which the plant was closed. Employers who temporarily close their plants have an incentive to reopen them if they are not paying the maximum tax rate. Each additional day of unemployment imposes additional costs in the form of higher payroll taxes. Yet firms which already are paying the maximum tax have no financial incentive to reopen plants and bear no additional costs as a result of the continued unemployment created.

Employers also face perverse incentives in other ways. An employer who is paying the maximum tax and has exhausted its reserve account does not bear any cost as a result of a job termination. As a result, the employer has no incentive to accurately report whether the termination was for misconduct (or some other disqualifying reason) and may conclude that it has some interest in helping discharged employees obtain benefits for which they are not qualified. Similarly, it is very difficult to verify whether beneficiaries are satisfying the work-search test without the cooperation of potential employers who interview them for jobs. Yet these potential employers have no financial reason to care about the issue.

**Perverse Incentives: The Unemployment Compensation Bureaucracy.** The administrative personnel within the Unemployment Compensation bureaucracy also face perverse incentives. On the whole, administrators receive no financial rewards for preventing overpayments and saving money for the system. If anything, there may be financial penalties. Agency personnel tend to be evaluated on "production" (processing claims) rather than on saving money by preventing

overpayments.<sup>39</sup> Moreover, once payments are made, agency personnel may find that it is not in their self-interest to "discover" later how many mistakes they have made.

## **THE POLITICS OF THE UNEMPLOYMENT COMPENSATION SYSTEM**

In 1987, \$16.5 billion was spent on the Unemployment Compensation system, including its two ancillary arms -- the Employment Service and the Bureau of Labor Statistics. Not surprisingly, a program of this size generates powerful special interests within the administrative bureaucracy and attracts outside special interests as well.

We have already noted how forces within the bureaucracy have prevented the public disclosure of embarrassingly high error-in-payment rates and overpayments of benefits. What follows is a brief summary of other ways in which special interest politics increasingly are shaping and molding the Unemployment Compensation system.

### **Politics At the Federal Level**

In its original design, the Unemployment Compensation system was supposed to operate as a federal-state partnership, with state governments free to impose and collect taxes to pay benefits and to set eligibility levels for beneficiaries. In practice, however, the federal government acts as the custodian of all taxes collected and exerts considerable control over how the money is spent.

**The FUTA Trust Fund.** Even though state governments impose and collect from employers their own Unemployment Compensation tax, this money can only be used to pay benefits when due. A second tax on employers, the Federal Unemployment Tax Act or FUTA tax, is collected by the IRS and deposited with the U.S. Treasury. The FUTA tax pays for federal/state administrative costs and the federal share of extended benefits, and creates a reserve from which states with defunct trust funds can borrow. The FUTA trust fund is included in the federal unified budget and any increase in the "surplus" in the fund helps lower the reported federal government deficit.

Like the Social Security trust fund, the Medicare trust fund, and many other trust funds managed by the federal government, the FUTA trust fund is a "trust fund" in name only. No money is being stashed away in bank vaults for safekeeping. Instead, every dollar that comes in is immediately spent -- on the Unemployment Compensation system or on some other spending program. The only assets being held are U.S. government bonds -- I.O.U.s which government writes to itself.

The FUTA trust fund surplus, then, is not a real "surplus." Theoretically, the "surplus" represents a promise by the federal government to impose future taxes to raise general revenues. Practically, the "surplus" represents a means by which

---

<sup>39</sup>Burgess and Kingston, *"An Incentives Approach to Improving the Unemployment Compensation System,"* pp. 187-191.

Congress can use Unemployment Compensation tax money to fund other spending programs.

Throughout the 1980s, Congress has increasingly yielded to the temptation to use the Unemployment Compensation system to fund other spending programs in this way. In 1975, a one-time surtax was imposed on employers to meet a deficit caused by federal supplement benefit payments. Yet the surtax was maintained far beyond the point when it was needed. In fact, despite cutbacks in administrative outlays and benefits since 1981 (and, thus, despite a steadily declining need for revenues), in 1987 Congress extended the surtax for three more years. As a result,<sup>40</sup>

- In 1987, the FUTA trust fund showed a surplus of \$2.9 billion.
- By 1988, the surplus rose to \$4.5 billion.
- By 1989, the surplus is expected to grow to \$8.3 billion.

**Funding Controls.** If a state is found to be "in compliance" with federal rules and regulations, the federal tax (FUTA tax) on employers is 0.8 percent on the first \$7,000 of wages. However, if a state is found not to be in compliance, the federal tax increases to 6.2 percent of taxable wages. Under these circumstances, employers within the state would face an additional 5.4 percent tax burden on top of the state taxes they already pay. Moreover, the state also would lose the administrative funds it now receives from the federal government.<sup>41</sup> To date, this draconian sentence has never been imposed. However, several states have been threatened with such actions and have been forced to appear before administrative hearings to determine their compliance. Thus, this tool alone is a powerful weapon by which administrators at the federal level can impose their will on the states.

**Other Controls.** The federal government, through the administrative arm of the U.S. Department of Labor, also has other techniques for enforcing Washington's preferences on states and localities and preventing many needed changes that state and local administrators would like to implement.

For example, the Department of Labor actually has the power to tell state governments not only how much they can spend to administer the Unemployment Compensation system, but also what programs can be operated with the money and how they are to be operated. Through complicated formulas that are often subject to administrative interpretation, department officials can use this power to punish or reward different programs in different states. Moreover, since the Department of Labor unabashedly proclaims that its principle function is to represent the views of labor in government, small wonder that it intentionally keeps state administrative budgets at unrealistically low levels. This practice virtually insures that overpayment of benefits in the system will continue to be extraordinarily high.

The Department of Labor also administers numerous programs that target funds for particular problems, such as the displaced worker program, the airline deregulation program and the work search verification program. If state officials find that the needs within the state are totally different from the "problems" the Department of Labor has

---

<sup>40</sup>Statistics and projections are those of the U.S. Department of Labor Actuary.

<sup>41</sup>In the worst case scenario, federal officials can actually step in and administer the state program.

targeted, the state has three choices: (1) It can "discover" that it has the very problems the Department of Labor has targeted, (2) it can spend the money "illegally" on other programs, or (3) it can return the money to Washington. The first two courses of action are more common than the last alternative.

### **Politics at the State Level**

Politicians and bureaucrats at the state level have a strong incentive (1) to manipulate the Unemployment Compensation system in order to reap benefits for their own constituents at the expense of taxpayers in other states, (2) to manipulate taxes and benefits to appeal to constituencies within their state, and (3) to manipulate federal rules in order to meet real local problems rather than Washington's view of local problems.

**Perverse Incentives.** As noted above, the Unemployment Compensation system -- from top to bottom -- violates the principles of genuine insurance. Opportunities abound to impose the cost of one's own behavior on other people. To state officials, the most important application of this perverse incentive is to find ways of creating benefits for residents of the state -- paid for by taxpayers in other states. To the extent that employment taxes can be kept low, business interests are satisfied and a climate is created that attracts investment and spurs economic growth. To the extent that benefit levels are kept high, this satisfies the interests of organized labor and the beneficiaries themselves. These twin objectives can both be satisfied, however, only by getting subsidies from other states.

By its design and structure, the Unemployment Compensation system encourages attempts by any one state to exploit all other states. Such exploitation was further encouraged prior to 1981, when state trust funds could obtain interest-free loans from the federal trust fund.

**Satisfying Local Constituencies.** It is not an accident that the "premiums" paid by employers do not reflect their employment experience or that work search requirements on the part of beneficiaries are not routinely enforced. These decisions are not made by private insurers on the basis of business and economic considerations. Instead, they are made through the political system and are shaped and molded by special interest politics. Thus, business interests routinely escape paying their "fair share" of taxes. In some states, the union hiring hall is allowed to determine whether workers have satisfied the work search test.

**Funding Administrative Costs.** By law, once tax revenues are placed in a state benefit trust fund they can be used only to pay benefits and not for the administration of the program. Moreover, as previously noted, the federal government has continually cut state administrative budgets despite a growing FUTA surplus. States have recognized how badly these budget reductions have hurt services and increased error rates. To address these shortfalls some states have found a way to get around these restrictions by "diverting" state employment taxes to an administrative fund before they are deposited in the state trust fund.

Other states are using state general revenue funds to augment their strained administrative budgets. As many as 28 states are spending as much as \$117 million of other tax money to fund the administrative costs of the Unemployment Compensation

system.<sup>42</sup> The result of this practice is that state and federal taxes on employers are higher than they need to be at a time when "surplus" FUTA funds are being used to finance other federal programs.

### **Politics At the Administrative Level**

Special interest politics asserts itself at the administrative level in numerous ways. Since the governor and legislature in almost every state approve the state's budget and salary levels -- in addition to hiring and firing upper-echelon staff -- much pressure can be brought to bear on an agency administrator or employee to change a decision. It is not uncommon to have legislators call an agency staffer or administrator and tell them of their constituent's problem, directing the employee to "fix" the problem by paying benefits. If the desired result is not achieved, budget or program hearings can become "uncomfortable" for the agency. These political pressures are hard to resist. In general, the average worklife of an agency administrator in the Unemployment Compensation system is only 2 1/2 years,<sup>43</sup> and in most states, agency administrators serve at the pleasure of the governor.

### **CHANGING INCENTIVES BY REFORMING THE SYSTEM**

The defects of the Unemployment Compensation system have been rigorously studied and are widely acknowledged by specialists in the field. There is far less agreement on what should be done to reform the system, however. Several pilot projects have been conducted in the United States in order to study the consequences of changing the economic incentives faced by beneficiaries. In addition, a number of European countries have introduced fairly radical changes in their unemployment insurance systems. What follows is a brief summary of these efforts.

**Cash Bonuses in Illinois.** In 1984, two experimental projects involved the payment of cash bonuses in cases where beneficiaries obtained employment. In the first test, beneficiaries received a cash payment of \$500 if they obtained employment of at least 30 hours per week before the end of the 11th week of unemployment -- about the average length of unemployment for U.C. beneficiaries. In the second test, the \$500 was paid to the new employer rather than to the beneficiary. Thus, in the second test, beneficiaries did not realize a direct financial gain, but they did have something positive to offer potential employers considering hiring them. The first experiment proved quite successful: <sup>44</sup>

---

<sup>42</sup>Statistics obtained from the Interstate Conference of Employment Security Agencies, Inc.

<sup>43</sup>*Ibid.*

<sup>44</sup>Stephen A. Woodbury and Robert G. Spigelman, "Bonuses to Workers and Employers to Reduce Unemployment: Randomized Trials in Illinois," *American Economic Review*, Vol. 77, No. 4, September, 1987, pp. 513-530.

- Among beneficiaries given the opportunity to participate, the average length of unemployment was one week shorter than among similarly situated individuals.
- Moreover, for every \$1.00 paid in cash bonuses, the state saved \$2.32 in reduced Unemployment Compensation benefits.

The second test was less successful, producing statistically significant differences in the behavior of only one group: white women. Among this group, however, the state saved \$7.07 in reduced benefit payments for every dollar it paid in bonuses. One surprising result of the experiment, however, was that only 12 percent of the employers who qualified for the bonus actually claimed it.<sup>45</sup>

**Cash Bonuses in New Jersey.** One defect in the Illinois experiment is that it provided the same financial reward to those who found a job in the first week of unemployment as it did to those who found a job in the 11th week. Since beneficiaries were also receiving regular unemployment benefits, those who found a new job in the 11th week actually received more total benefits than those who found a job more quickly. An experiment in New Jersey remedied this defect by changing the structure of the cash bonus in order to reward early re-employment. Specifically,<sup>46</sup>

- A beneficiary who found a new job was paid one-half of the remaining expected benefits.
- After the fifth week of unemployment, the bonus declined at a rate of 10 percent per week until it reached zero.
- On the average, it was expected that participants could receive about \$1,600 for finding a new job.
- An interim report shows that claimants receiving the bonus go to work about one week earlier, saving the state trust fund \$160 per claimant.

**Entrepreneur Lump Sum Payment in Washington.** The state of Washington has been chosen by the Department of Labor to operate a demonstration program which would pay selected claimants a lump sum benefit amount to be used by the claimants to start their own businesses. Such a program is already in place in some European countries. At the time of publication of this paper, this project is in the design phase and no details are available.<sup>47</sup>

---

<sup>45</sup>*Ibid.*, p. 527.

<sup>46</sup>"New Jersey UI Reemployment Demonstration Project Interim Report," New Jersey Department of Labor, June 1988.

<sup>47</sup>Information obtained from the State of Washington Department of Labor.

## CHANGING INCENTIVES THROUGH PRIVATIZATION

Evaluations of the Unemployment Compensation system, whether from individuals inside or outside the system, follow a consistent pattern. Problems with the system are documented, and a critical analysis demonstrates that the minuses outweigh the pluses. The people delivering services in the system are hampered by layers of red tape. The employer paying for the system sees overall costs accelerating while service declines. The claimant receives little long-term benefit from a system that sidelines individuals instead of capitalizing on an opportunity to identify and help them become more productive. The United States has a competitive need for a system that can assist the worker to make the necessary changes to effectively meet the challenges of the changing job market. The current Unemployment Compensation system and the attendant employment and training programs are not meeting this need.

The current system of warehousing claimants without providing them access to programs to upgrade skills or other alternatives to long-term unemployment is wasting the productivity potential of America. The current Unemployment Compensation program creates an aura of conflict between the employer and employee from the first day of employment to the last. The employer and the employee have much more to gain from a program under which they work together to increase worker and business productivity. A program is needed that will reduce overhead costs and complexity while directly involving the employer and employee in the decision-making process.

Privatization would abolish the current Unemployment Insurance System, Employment Service and Jobs Training Partnership Act programs. These would be replaced with Employment and Training Accounts (ETAs) -- one for each employee. The individualized ETAs would be administered by participating financial institutions for a fee. Statutory authority for such a program would come from the IRS Tax Code. Utilization of the account would be governed by a simple set of guidelines and where necessary by agreement of the employer and the employee.

Funds deposited in a worker's ETA would become the private property of the worker. These accounts would be similar in nature to an Individual Retirement Account or funds deposited under a Deferred Compensation plan. During an individual's active worklife, funds in an ETA could be used for job-training, job relocation, job-placement or as a source of income replacement during periods of unemployment. In the event of death, disability or retirement, funds in the ETAs would revert to the workers or their heirs. Amounts withdrawn and used for income replacement would be taxed as ordinary income -- just as Unemployment Compensation benefits are now taxed. Funds used for job-training, job relocation or job placement would not be included in the individual's taxable income.

**Individual Employee Accounts.** ETA accounts for all workers would be mandatory for anyone employed 90 days with the same employer. The ETA could only be used by the employee with an assigned account number (similar to a Social Security number). The ETA would be created by both the employer and employee paying into the account. Each would make minimum weekly contributions of \$13.50 or 2.7 percent of salary, whichever is lower. Thus, the combined weekly contribution would be \$27.00 or 5.4 percent of salary, whichever is lower, and these contributions would be excluded from the worker's taxable income. Employers and employees also would be allowed to contribute more than the minimum required contributions to ETA accounts. This opportunity would be especially important for firms and industries



which experience high turnover rates. The maximum tax-deductible weekly contribution would be \$27.00 or 5.4 percent of income, whichever is higher.

For each employee, the ETA fund would accumulate for each week of employment and contributions would cease when the employee's account reached \$7,000 -- an amount roughly equal to the maximum benefit employees can currently receive in Unemployment Compensation in some of our most generous states. The payments made would be held in an interest-bearing ETA administered by any participating financial institution chosen by the employee.

**Job Training.** During periods of active employment, the ETA could be used in a number of ways to finance job training by agreement of the employee and employer. Training identified as being needed would be paid for from the account with the employer's agreement. Acknowledgment of such an agreement would be indicated by a certificate signed by the employee and employer. Funds would be payable to any IRS-qualified training program upon presentation of the certificate to the participating financial institute. Employers also could set up their own IRS qualified training programs and receive payments from the workers' ETA accounts. Such programs, however, would have to consist of substantial departures from ordinary on-the-job training which takes place in the normal course of business. During periods of unemployment, workers would remain free to apply their ETA account funds to the cost of training at any qualified training program of their choice.

**Short-Term Layoffs.** In the event of a short-term, temporary layoff not exceeding ten weeks, the employees would be eligible to draw up to one-third of the amount of their ETA. The payment amount could be made as a lump sum or biweekly payment, depending on the employee's preference. If the layoff exceeded ten weeks, employees could then withdraw 100 percent of the funds from their ETA. Again, this money could be drawn as a lump sum or in biweekly payments. Once employment resumed, payment into the account would resume at the standard rate by employer and employee.

**Long-Term Layoffs.** In the event of a long-term or permanent layoff, the money from the account could be used according to the preference of the employee. Job-training costs, job-placement costs, relocation costs or the creation of a new business could all be paid for from the ETA. If the money was used for one of these qualifying purposes, the money so used would be tax free.

**No-Fault Withdrawals.** Layoffs for any cause would be treated as no-fault layoffs. The employee and employer would simply certify that the separation had occurred. Thus, there would be no need to determine whether the employee had "quit" or whether the termination was the employee's fault.

**Death and Disability.** If the employee is permanently disabled, the employee receives 100 percent of the money in the ETA account. If the employee dies, 100 percent is paid to the designated beneficiary of the employee.

**Transition Period.** For a worker earning the median wage paid to full-time, adult male workers in the labor force, it would take about five years for the worker's ETA to accumulate \$7,000. Thus, on the average, a transition period of approximately five years is needed in order for a fully functioning private system to be put in place. Over this period, the current system of Unemployment Compensation benefits could be phased out by reducing benefit levels by 20 percent in the first year, and by equivalent amounts in succeeding years. For high-income workers whose ETAs will build up

more rapidly, promised Unemployment Compensation benefits would be reduced more swiftly. Conversely, for low-income employees, the phasing out of promised Unemployment Compensation benefits might proceed more slowly.

## CONCLUSION

Today's Unemployment Compensation system has grown into a morass of complex programs that cost employers in excess of \$15 billion each year. The complexity of these programs, operated through a federal-state partnership, create an error rate which is estimated to exceed \$2 billion per year. The dual administration by federal and state governments duplicates oversight of programs and tax collection, causing additional costs and ineffective program management and control. The benefits paid to the unemployed act as an "economic methadone," neither upgrading the marketable skills of the unemployed nor contributing to an increase in worker productivity. This stagnation causes unemployment to recycle, causing the United States and its workers to lose ground in the competitive international economic environment.

The emerging industries of the 1990's will create jobs for the unemployed, but the system does not provide a vehicle to allow for training to qualify these workers. The dollars wasted by nation's Unemployment Compensation system pale in significance to the waste it tolerates in human resources and productivity. The proposed private system would give the unemployed choices by creating an Employment and Training Account (ETA) that is controlled by the worker. The unemployed worker could opt to spend money from this account on job training, classes for upgrading skills, job-finding assistance, relocation costs, business creation, income supplementation or a combination of the above. Since workers are spending their own money when they use their ETA funds, they have excellent incentives to avoid waste and make decisions wisely.

The employed worker also could use this fund with employer approval to upgrade skills, take classes or receive on-the-job training. The employer, with permission of the employee, could provide the same opportunity for the worker utilizing the ETA as a resource. The cooperative aura created by a program of such mutual benefit provides a vehicle to foster a better employer/employee relationship. The system today injects a divisive spirit into the employer/employee relationship which causes abuse of the relationship and misuse of the program. The joint access in the ETA account will provide a self-policing mechanism that will deter and limit fraud or abuse by either the employer or employee.

The abolition of federal and state administrative staff will produce large savings and reduce the federal budget deficit. The proposal would place administration in the hands of the private sector at a fraction of the cost. The "no fault" feature of separation will eliminate the number of unemployment insurance cases that reach the courts, saving additional time and expense. The proposed system will shift decision-making responsibility from public employees to the unemployed individual. This will give individuals direct control over their own funds and allow self-determination to direct success or failure in the workplace.

NOTE: Nothing written here is to be construed as necessarily reflecting the views of the National Center for Policy Analysis or as an attempt to aid or hinder passage of any bill before Congress.

## APPENDIX A

### AN OVERVIEW OF THE UNEMPLOYMENT COMPENSATION SYSTEM

The Unemployment Compensation system operates in all 50 states plus the District of Columbia, Puerto Rico and the Virgin Islands. It is a federal-state partnership funded almost solely by two taxes on private sector employers. The Federal Unemployment Tax Act (FUTA) tax is collected from employers by the Internal Revenue Service. Money from these taxes is deposited and invested by the United States Treasury. The purpose of the FUTA tax is to pay for administration of the program by the United State Department of Labor. In addition, this tax finances state unemployment insurance administrative costs. These operational dollars do not flow directly to the states but are budgeted by the Department of Labor through the congressional budget process. The states, while given input into the budget process, actually have very little control of the amount of dollars allocated or the programs funded. This leaves the states little fiscal flexibility or program autonomy for the operations they must administer, regardless of suitability or need.

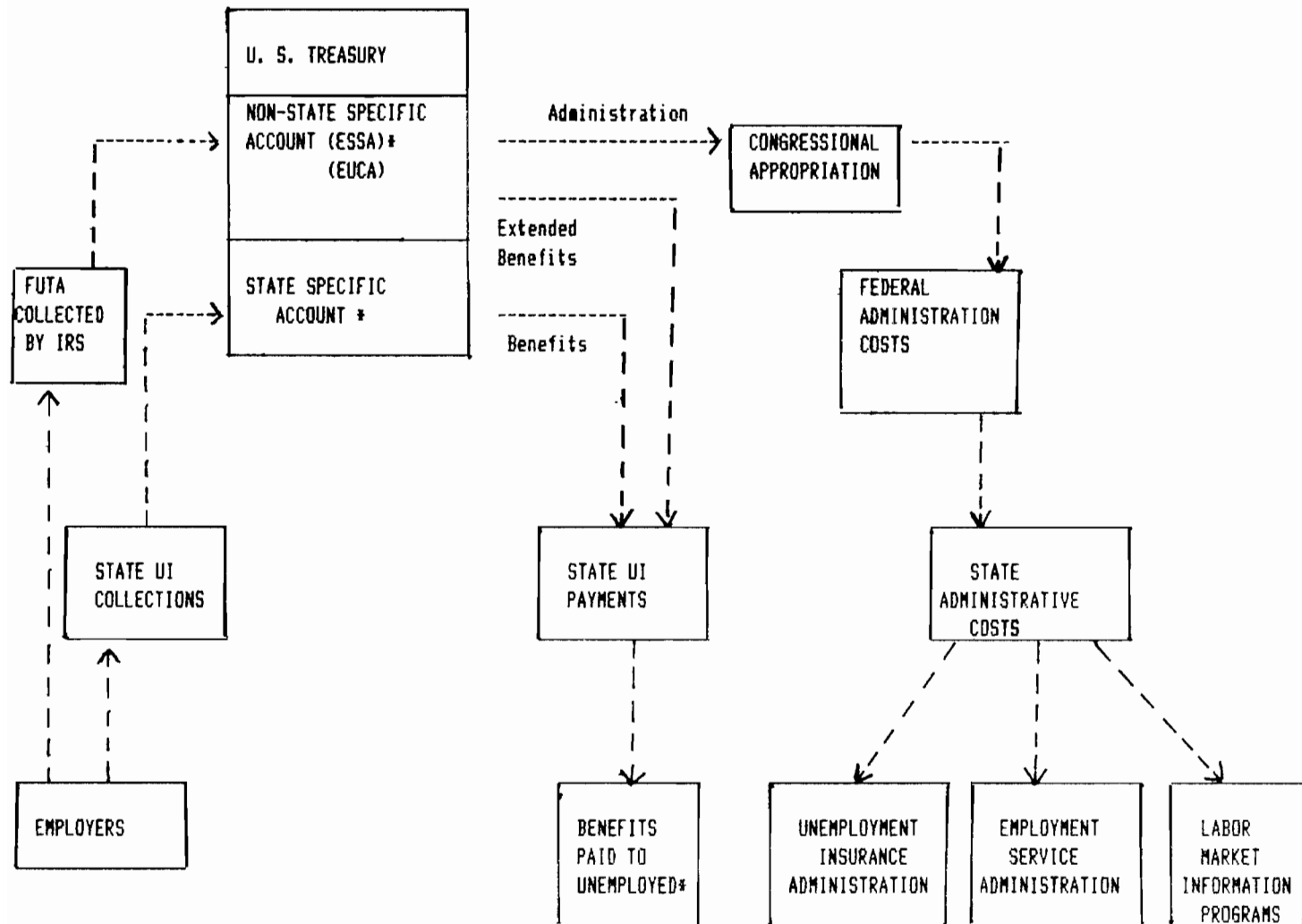
Those dollars not spent on federal-state program administration pay for the federal share of extended benefits and create a loan fund for jurisdiction states whose benefit trust funds become insolvent. The FUTA tax also pays for both the federal and state administrative costs of the ES and BLS programs. Both of these programs are administered by federal oversight agencies and with contracts with the state for job placement, data collection, and data analysis. As with the Unemployment Insurance program, the states have little latitude in the design and direction of ES or BLS programs, yet they assume program and fiscal accountability.

A second tax on employers is levied and collected by the states to create their individual trust fund from which benefits are paid to eligible claimants. This tax and the trust fund it creates is managed by the states. Benefit and tax levels are established by the state agency through their state legislature. The states also set the Unemployment Insurance benefit eligibility criteria. The trust fund is singularly owned by the state, although the money resides in the federal treasury and is invested by the federal government. The total amount of FUTA and state trust fund dollars (both revenues and outlays) are contained as line items in the federal unified budget.

In addition to the federal-state unemployment insurance program there are two satellite functions that are still funded by the system today. The first is the collection and dissemination of information about the labor market. The Bureau of Labor Statistics (BLS) has evolved as the official statistical data collection and analytical arm of the program.

The second satellite function of unemployment insurance is the Employment Service (ES), which was created to provide a local office network of job placement for the Public Works Administration. Today, the Employment Service is financed by the same tax that funds unemployment insurance administration. It serves as a job placement network for employers and job seekers and is considered by many to administer the "work test" for Unemployment Compensation.

FLOW OF FUNDS FOR UI BENEFITS AND ADMINISTRATION



## ABOUT THE AUTHOR

Raymond P. Thorne served as chief administrator of the Employment Division for the state of Oregon from 1977 to 1987. During that time, he was one of the key forces behind the Bliley-Warner Bill in Congress, which was designed to end the federal government's involvement in the Unemployment Compensation system. Although the bill did not pass, it did pave the way for greater control of the system by individual states.

In a 1981 article, *Forbes* magazine lauded Thorne's efforts to ferret out cheaters in the system. The article reported that Thorne's work search verification program saved Oregon taxpayers \$783,000 in December, 1981 alone. The Interstate Conference for Employment Security Administrators recognized Thorne's efforts to reform the system by naming him Outstanding Administrator for 1986.

Thorne first held public office in 1974, when he was elected county commissioner in Klamath County, Oregon. A former high school teacher, he holds a B.S. in Science Education and an M.S. in Biology from Oregon State University. Thorne now lives in Salem, Oregon, where he is a businessman.