

# Unemployment Insurance Programs: A New Look for the Eighties?

*By Robert J. Rossana\**

Public interest in employment policy has tended to focus on limiting overall unemployment to a certain percentage of the labor force. The Full Employment and Balanced Growth (Humphrey-Hawkins) Act of 1978, for example, requires that policymakers attempt to achieve an unemployment rate of 4 percent by 1983. Clearly, reducing unemployment is high on the policy agenda. There is some evidence, however, that current insurance programs which provide compensation to the unemployed may work against achievement of precise statistical goals.

The reason seems to be that, with the advent and growth of job insurance, temporary layoffs have become much more common. Workers have come to expect them and to regard unemployment benefits as a part of

the income package they get when they choose among places to work. And employers have become more inclined to lay off workers during periods of low demand than to go through the cycle of firing, hiring, and training as demand fluctuates—especially since employers don't pay the whole insurance cost.

Thus unemployment insurance programs, while easing the hardship of job loss for many workers, may have contributed, quite unintendedly, to raising the level of unemployment in the economy at large. As policymakers struggle to get within the overall unemployment goals set by Humphrey-Hawkins for the decade ahead, they may need to restructure these programs to reduce their unemployment side effects while still providing for their primary function—easing the burden of job loss.

## HELPING THE UNEMPLOYED

Programs designed to aid the unemployed

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\*Robert J. Rossana joined the Philadelphia Fed's Department of Research in 1978. Trained in economics at the Johns Hopkins University, he specializes in real-sector policy.

were established in some parts of Europe as early as the eighteenth century. But it wasn't until the early part of this century that unemployment compensation programs became a permanent part of the economic landscape.

The American experience with these programs dates from the 1930s, when the national economy was in the throes of a depression and unemployment was at an all-time high. With the passage of the Social Security Act of 1935, the U.S. made its first large-scale attempt at compensating people who had lost their jobs.

From the beginning, legislators thought that compensation programs should be run jointly by Federal and state governments to ensure that they would be flexible enough to meet differing needs in various regions of the country. The result has been that, with each state largely free to develop its own program, the details of programs have differed from state to state, with rules for eligibility, payments, and the like varying greatly. But despite their diversity, these programs have one feature in common—their strong growth record.

One way to measure their growth is to look at the increase in the range of workers they have come to include. At first, job losers in agriculture and government were excluded from compensation programs, as were employees of firms which hired fewer than 20 people. As experience accumulated, policymakers extended the coverage of the system to include most members of these groups. Figure 1 gives some idea of how inclusive unemployment compensation has become. This figure, which represents the situation up to 1973, shows that the percentage of paid employment covered by state programs has risen over time in a number of industries. With more recent changes in law, it is likely that over 90 percent of potentially coverable employees now are eligible to receive insurance benefits.

Another way to get a feel for the growth of these programs is to look at the duration and

dollar value of their benefits. Most states now authorize benefits for a period of up to 26 weeks, with extensions to 39 weeks in times of high unemployment. Congress has the power to authorize further extensions to 52 or even 65 weeks for certain areas during recessions or other periods of persistent high unemployment. In 1976, the nationwide average for duration of benefit payments was just under 15 weeks, with state averages ranging from slightly under 10 weeks to slightly over 20 weeks.

The average weekly benefit paid out, considering all groups of recipients, currently stands at about \$82 nationwide, ranging from a low of about \$60 in some states to a high of over \$100 in the District of Columbia. And considerably higher levels of income support are available in some places, up to a high of \$174 weekly in Connecticut for a worker with dependents. Over the quarter century 1950-74, average benefits paid per week rose further (51 percent) than average weekly earnings (42 percent) in real terms.

**FIGURE 1**

**PERCENTAGE OF EMPLOYMENT COVERED BY INSURANCE HAS RISEN SHARPLY**

Industry	Percentage Covered		
	1939	1960	1973
Agriculture	0	8.1	25.7
Manufacturing	94.7	99.2	100.0
Services	49.0	54.5	88.8
State & Local Government	0	5.8	25.2

SOURCE: Adapted from Daniel S. Hamermesh, "Jobless Pay and the Economy," The Johns Hopkins University Press, 1977.

In total, the benefits paid out by the states rose from a level of \$1.2 billion in 1939 to \$10.5 billion in 1975 (in 1987 dollars). At roughly 13 percent of all government transfer payments, jobless benefits were unusually high in the 1974-75 recession, when unemployment hit a postwar peak. But even adjusting for business cycle fluctuations, the numbers show that jobless pay programs have become a major activity of government.

While people may qualify for compensation for a variety of reasons, those on temporary layoff—still tied to firms but not currently working—have been among the chief intended beneficiaries of compensation programs; and they continue to make up a sizable percentage of the unemployed. Thus it's especially useful to look at how current programs have affected their behavior and that of their employers.

**WHAT THE NUMBERS SAY**

Many people immediately think of layoffs when they hear the latest figures on unemployment. In fact, total unemployment includes individuals who are unemployed for reasons quite unrelated to layoff.<sup>1</sup> But the Labor Department's Bureau of Labor Statistics does publish other figures that apply just to those on layoff.

**The Current Population Survey (CPS).** The CPS is the source for the official unemployment rate estimates issued by the BLS. It is a monthly survey of a very large number of households and gives detailed information on temporary layoffs.

Figure 2 presents data from this survey for March 1974—a month well into the last recession's drop in demand. The data refer to men aged 25-64. Men in this age bracket, at least those in the upper end of it, are not likely to be unemployed for reasons other than layoff. These men typically feel more or less permanently attached to their employers

because they are the primary breadwinners in their families, because they have vested pension rights, or because they find it difficult to change jobs by reason of age.

The CPS data are revealing. During the sample month, the national unemployment rate was 5.3 percent and was rising because the economy was in a business downturn. Over 40 percent of all male job losers in the 25-64 age bracket lost their jobs because of temporary layoffs—about half of total unemployment. Further, the duration of unemployment was relatively short for these men, averaging 3.6 weeks for those on fixed-duration layoff (30 days or less) and 11.4 weeks for those on indefinite-duration layoff (over 30 days). Finally, most laid-off workers apparently expected to be recalled by their employers, since very few were searching for new jobs in the week prior to the survey. Only 15 percent of those on indefinite-duration layoff were job searching. An even smaller percentage of those on

**FIGURE 2**  
**FOUR OUT OF TEN JOB LOSERS ARE LAID OFF**

	Job Losers on Layoff (Percent)		
	Total	Fixed Duration	Indefinite Duration
<b>Men Aged 25 - 64</b>			
Percent of All Job Losers	40.4	13.0	27.4
Percent of Job Losers Who Search	11.9	4.6	15.4
Average Duration in Weeks	8.9	3.6	11.4

SOURCE: Adapted from Feldstein. Figures are as of March 1974.

<sup>1</sup>A host of reasons can be advanced. People may quit, for example, to look for a better job; or they may re-enter the labor force after caring for a family.

fixed-duration layoff were searching.<sup>2</sup>

Thus the CPS data suggest that, during periods of reduced demand, a large part of national unemployment is made up of those on temporary layoff, temporary layoff unemployment is of rather short duration, and people on temporary layoff tend not to look for other jobs.

#### HOW PEOPLE—AND FIRMS—BEHAVE

Economists assume that people are always maximizing something. Firms are assumed to maximize profits; workers are assumed to maximize their own welfare. In short, it's expected that workers and firms will respond to economic incentives. These assumptions provide the key to linking unemployment compensation to the job-search and layoff decisions workers and firms make. How do workers change their behavior because of unemployment compensation? And how do firms respond to the fact that, because of the way unemployment programs are financed, they don't bear the full cost of compensating the people they lay off? A useful approach for investigating these questions, which takes account of both worker and firm behavior, has been presented by Martin Feldstein (see SUGGESTED READINGS).

**The Employee Viewpoint: Maximize Welfare.** According to Feldstein, American workers are a pretty savvy lot, well aware of the income alternatives they face. They know that they pay taxes on ordinary income. They know that the unemployment compensation they receive when laid off, though it may be lower than gross wages, isn't taxed.

<sup>2</sup>These numbers represent the period out of work at the time the survey is taken. They don't indicate what happens after the survey—whether workers continue on layoff or are recalled. Thus they may not give a completely accurate picture of layoff duration.

Classifying layoffs by duration is somewhat arbitrary, but it does give us a feel for how likely it is that a worker actually will be recalled. Also, those on indefinite layoff themselves probably attach a lower probability to recall than those on fixed-duration layoff.

The difference between the positive tax rate on wages and the zero tax rate on compensation is, technically, a subsidy (see Appendix).

In principle, workers also know something about the layoff decisions of the firms they might work for. A person considering employment at General Motors presumably can gather accurate information about past layoff decisions at GM and other potential employers. Having gathered this information, the worker can choose a package that will make him as well off as possible. This package may include both time on the job at one after-tax income level (wages minus taxes) and time off at another level (unemployment benefits).

Workers who anticipate layoffs have two choices open to them when they finally are laid off. They may search for another position, or they may engage in nonmarket activities. Those who choose to search presumably will be looking for a better package and so will not go back to work unless they find one. Those who don't bother to search remain inactive even though they might have been able to find another job. Both of these options are made more attractive than taking the first opening that comes along because unemployment insurance replaces a large portion of net wage income—from one-third to two-thirds, by most estimates.<sup>3</sup> So unemployment programs affect the behavior of workers whether or not they search.

**The Company Viewpoint: Maximize Profits.** Firms are presumed to be interested in profits. To be profitable, they must take account of, among other things, all their labor costs, including direct costs such as wages and benefits and indirect costs such as recruiting, training, and paying taxes to the unemployment insurance fund.

Faced with a decline in demand for its products, a firm may reduce either hours or

<sup>3</sup>See, for example, Feldstein, "Unemployment Compensation: Adverse Incentives and Distributional Anomalies."

employment or both in order to cut its wage bill. Reducing employment has a cost attached to it, since the firm pays unemployment insurance taxes. But since firms typically are not taxed for the full amount paid out in benefits to the people they furlough, layoffs are cheaper than they might be. Thus firms receive a subsidy for their layoff behavior.

Most states levy unemployment insurance taxes on all employers at a basic rate and use a formula to determine how much more a firm will have to pay over and above the minimum up to a certain maximum rate. The idea behind this approach is that percentage increments should be based on a firm's layoff history in the insurance program. Thus firms that have made more layoffs than average in the past are expected to pay taxes above the basic rate. Pennsylvania, for example, has a formula which compares benefits paid over several years to average payroll over the same period. But state formulae typically do not place the whole burden on the employer who makes the layoffs, because any payouts that exceed the employer's maximum liability will be underwritten out of the fund, which comes from other employers' contributions and from other sources. Also, because of lags in recomputing the experience record, a firm that exceeds its historical layoff levels will have a grace period before it begins paying even the formula rate that corresponds to its current layoff behavior. The upshot is that many firms do not pay the full cost of layoffs.

Further, if a firm's management knows either that employees on layoff will not seek alternative employment or that, even though job seeking, they are likely to be available for recall, then the firm can recall these workers without having to pay for recruiting and training as it would if it hired new employees. In this way, the firm avoids some of the costs attached to increasing its labor force when demand is restored to its old, higher level.

In sum, the effects of the subsidy make layoffs cheaper than they would otherwise

be, providing an incentive for businesses to furlough more workers and, if necessary, to increase the number of hours worked by remaining employees during periods of reduced demand.

**For Example.** These effects on worker and employer behavior can be highlighted by imagining how the economy would look without the unemployment subsidy.

A potential employee considering employment with two firms would be concerned not only with the wage he could earn but also with the other characteristics of the job, such as fringe benefits, advancement potential, and working environment. Additionally, the riskiness of the job—that is, the probability of layoff—would be an issue. Suppose that these two firms were identical in every way except that one firm had made more layoffs in the past. In the absence of the unemployment subsidy and if this worker were at all risk averse, then the firm that had made more layoffs probably would have to offer a higher wage rate. It would have to do this in order to induce people to accept employment in a more uncertain job rather than a safer one. That is, a risk premium would arise in this labor market.

Now put back the unemployment subsidy. The riskier firm no longer has to offer as high a wage since workers can look forward to receiving unemployment benefits while on layoff: potential employees are more likely to accept employment with this firm because they know that they can count on unemployment benefits.

The example clearly shows that firms with relatively volatile employment policies are being subsidized to the extent that the wage rate they can offer is lower than it would be if there were no unemployment insurance. Since the unemployment subsidy to employers distorts the wage rates which would prevail without the subsidy, compensation programs, as currently constituted, lead to an inefficient allocation of resources in the economy, and society gets less output from its resources.

There is another way to bring out the inefficiency occasioned by the unemployment subsidy. When employees are laid-off, neither those who spend all their time searching nor those who simply take time off at a reduced income level are producing anything. In this framework, laid-off workers are, from society's viewpoint, searching too much or taking too much time off. Society gives up the output which these workers otherwise could produce. Thus, because of the unemployment subsidy, fewer goods and services are made available, and prices for these goods and services tend to move upward.<sup>4</sup>

While it's difficult to get a tight handle on the exact size of the employers' subsidy (because the tax rate they pay is not readily available), the subsidy to workers has been estimated fairly closely. To make this estimate, Feldstein has used the benefit replacement ratio—the ratio of unemployment benefits to lost after-tax wages. The benefit replacement ratio is constructed from information on state unemployment compensation rules, employment histories of individuals, and individual tax rates including Social Security, adjusting for other factors.

Simply stated, Feldstein's results are that, during periods of reduced demand, the higher the unemployment subsidy to workers, the higher will be both the amount of unemployment and the hours worked per remaining employee. Feldstein estimates that, in 1971, the average benefit replacement ratio explained about half of temporary layoff unemployment. And an increase in this ratio from 40 percent to 60 percent, he figures, raised the predicted temporary layoff unemployment rate by about half a percentage point.<sup>5</sup>

<sup>4</sup>This assumes that the money stock remains constant. Actually, of course, the money stock doesn't remain constant, so that the impact of changing output levels is harder to ascertain.

<sup>5</sup>Feldstein, "The Effect of Unemployment Finance on Temporary Layoff Unemployment."

Thus the incentives produced by policymakers' attempts to ease the burden of unemployment actually led to more layoffs, he finds, and therefore to more unemployment, than would otherwise have occurred.

#### WHAT DOES IT MEAN FOR POLICY?

Unemployment in the form of temporary layoff affects many Americans during their working years. No one can quarrel with the idea of protecting people from the potentially disastrous consequences of a sudden income loss. But recent research suggests that this protection has come at a high social cost. The present method of financing unemployment insurance, which does not fully tax firms to cover the payments made to their employees on layoff, results in making layoffs cheaper to the firm than they would otherwise be. The cheaper the layoffs, the more layoffs firms will make. The current taxation scheme does not provide the appropriate incentives for firms to be more careful with their layoff decisions.

Since ordinary income is taxed at a higher rate than unemployment benefits, people in the labor market are subsidized too much from the point of view of society as a whole. Workers are more likely to accept employment at firms with relatively volatile employment practices since they know that they will be supported by the unemployment subsidy. Thus the wage rates that would prevail in the market in the absence of such a subsidy are distorted and lead to a less efficient allocation of resources in the economy. If workers search for a new job while laid off, they'll search too long from society's point of view. Society gives up the output, for too long a period, that these unemployed workers could produce. If unemployed workers choose to take leisure while on layoff, society again forgoes output that it could otherwise consume.

Thus a restructuring of the unemployment insurance system apparently would help to reduce the national unemployment rate. If compensation benefits were taxed at the

same rate as ordinary income, for example, workers on layoff would have more of an incentive to search for new jobs. And those who would search as a matter of course probably would spend less time looking before accepting a job offer. In each case, the ranks of the unemployed would be thinned. To insure that taxation of benefits did not create a major burden for low-income earners, a tax rebate could be paid if a worker's income were to fall below some target level.

Forcing firms to bear the full cost of their layoff decisions also might yield a reduced unemployment rate. This would require elimination of ceilings and floors on the amount of taxes paid to finance unemployment benefits. Then firms experiencing a highly variable demand for their product would be less inclined to lay off workers since they would no longer receive a subsidy from firms with more stable employment practices and from the public at large. Such a policy shift, of course, could have adverse

side effects: firms might be less willing to make new hires, for example, if the cost of layoffs were increased. But these effects might be mitigated by limiting the time during which a firm was fully responsible for financing its layoffs to a certain number of months per worker—say, two or three months.

Perhaps it is best to view these results as suggesting a list of structural reforms designed to reduce unemployment among various groups. The unemployment compensation side effects are pertinent mainly to older, mature workers suffering short spells of unemployment, not to younger ones with few job skills. Wage subsidies or a reduction in the minimum wage may be the key elements in dealing with this latter group. But it is only when we undertake a whole range of reforms that we can hope to make substantial progress in permanently lowering the overall unemployment rate while still providing job-loss protection where appropriate.

### SUGGESTED READINGS

The four papers by Martin Feldstein that provide the background for this article are: "The Importance of Temporary Layoffs: An Empirical Analysis," *Brookings Papers on Economic Activity* 3 (1975); "Unemployment Compensation: Adverse Incentives and Distributional Anomalies," *National Tax Journal* 27, 2 (June 1974); "Temporary Layoffs in the Theory of Unemployment," *Journal of Political Economy* 84, 5 (October 1976); and "The Effect of Unemployment Insurance on Temporary Layoff Unemployment," *American Economic Review* 68, 5 (December 1978). For a somewhat different view which explicitly incorporates uncertainty, see Martin Neil Bailey, "On the Theory of Layoffs and Unemployment," *Econometrica* 45, 5 (July 1977).

## APPENDIX

The unemployment subsidy which has been shown to be relevant to the layoff decisions firms make can be defined algebraically.

Using Feldstein's notation, the unemployment subsidy,  $J$ , is defined as

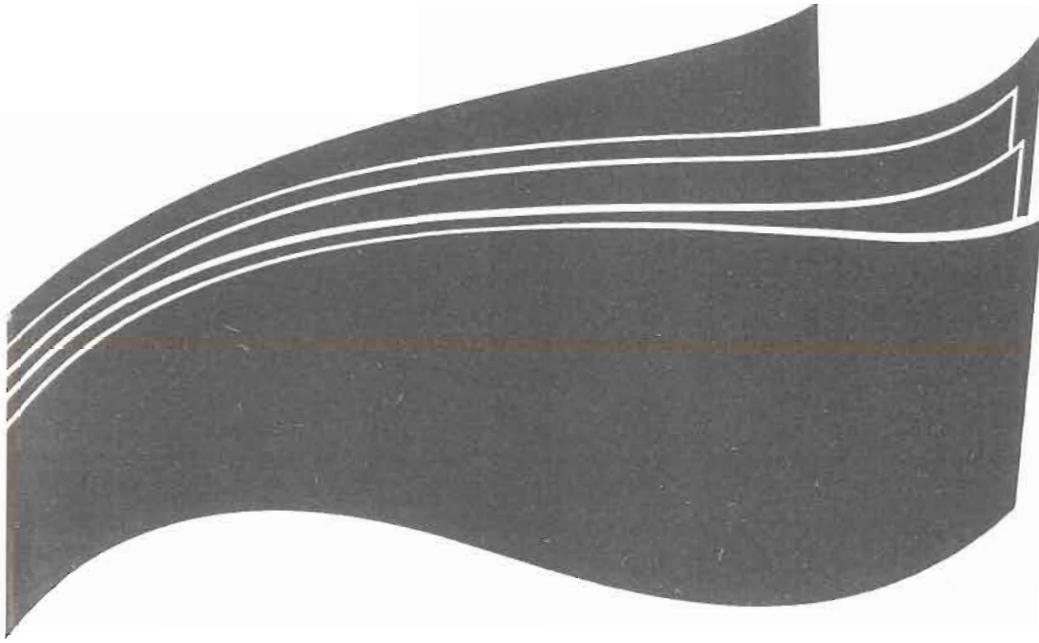
$$J = [(1 - t_b) - (1 - t_y)e]b/(1 - t_y),$$

where  $t_b$  is the tax rate on unemployment insurance benefits,  $t_y$  is the tax rate on ordinary income,  $e$  is the tax rate paid by firms to finance benefit payments, and  $b$  is the amount of benefits paid per worker on layoff. The subsidy can be eliminated ( $J$  can be set equal to 0) for any level of benefit payments. To eliminate the subsidy it is required that

$$(1 - t_b) = (1 - t_y)e.$$

The subsidy will disappear if  $t_y = t_b$  and if  $e = 1$ . That is, if ordinary income and unemployment compensation are taxed at the same rates and if firms are fully liable for payments made to their employees on layoff, then there will no longer be any subsidy to workers or firms. Feldstein shows that the higher  $J$  is, the lower employment will be during a period of reduced firm demand.

Further details are given in Feldstein, "Temporary Layoffs in the Theory of Unemployment."



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