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Now is the time to reform unemployment insurance -- before it's really needed.

By ALAN B. KRUEGER

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THE unemployment insurance program was neglected during the steady stream of good economic news in the 1990's. States usually add to their unemployment insurance trust funds in prosperous times, so they can draw them down in weak times. Perhaps believing the good times would never end, however, many states have failed to replenish their unemployment insurance funds or make other fundamental changes that would strengthen the system.

Even in the new economy, unemployment insurance still serves a valuable purpose. The amount a family spends on food -- a bare necessity -- falls 7 percent, on average, when the head of a household becomes unemployed, according to a study published in The American Economic Review by Jonathan Gruber of the Massachusetts Institute of Technology. Absent unemployment benefits, he estimates that a spell of unemployment would cause food consumption to fall 22 percent -- about three times as much.

Indeed, with workers increasingly being promised stock options in exchange for lower base pay, laid-off workers who are ineligible to cash in on their options -- even if they are still worth something -- are likely to depend on unemployment benefits even more to help pay for housing and groceries.

Offsetting the salutary "consumption smoothing" effect of unemployment benefits, many economists have also documented a distortionary effect: as benefit generosity increases, workers tend to remain unemployed longer. Higher benefits apparently reduce the amount of effort people devote to searching for a job. In addition, research indicates that some employees and employers game the system, placing workers on temporary layoff so they can receive benefits while on vacation.

But these unintended consequences do not mean the program should be scrapped. Doctors do not stop prescribing medicines just because they have unintended side effects; instead, they weigh the expected benefits of treatment against the cost of the side effects, and proceed accordingly.

Ideally, the optimal unemployment benefit would balance the desired consumption-smoothing effect against the undesired distortionary effects. According to Professor Gruber's calculations, the average unemployment benefit in the United States, which replaces around 40 percent of previous earnings, after taxes, is close to the optimal level given workers' aversion to the risk of job loss.

The program is worth preserving. So it is important to ensure that sufficient financing is accumulated in state trust funds to weather a possible downturn.

A common measure of the solvency of unemployment insurance funds is the reserve ratio, or accumulated funds as a percent of annual payroll. A higher reserve ratio provides more protection in the event of a downturn. Phillip B. Levine, an economist at Wellesley College, calculates that to remain solvent through a severe recession, like the one experienced in the early 1980's, unemployment insurance funds would require a reserve ratio of at least 1.25 percent. Using this standard, 14 states are now at risk of insolvency in a severe recession.

Texas and New York, with reserve ratios of 0.31 percent and 0.44 percent -- the lowest in the nation -- are skating on particularly thin ice. The funds in these states are at risk of insolvency even in a mild downturn.

Moreover, it would be prudent to build up reserves in excess of the minimum level because state finances are likely to be strained in the next downturn because the new federal welfare law, Temporary Assistance to Needy Families, does not increase state block grants in a downturn. Additionally, lifetime limits on welfare payments could induce more displaced workers than in the past to apply for unemployment benefits.

The way unemployment insurance is financed can be improved to reduce its unintended distortionary effects and to shore up the trust funds.

Employers are assessed a tax on each worker's earnings, up to an annual earnings cap that has not kept up with inflation. The tax rate depends on an employer's past experience with layoffs -- a process known as experience rating -- subject to a minimum and maximum rate.

Largely because of these limits, experience rating is imperfect. The extra tax revenue generated by additional layoffs covers only about two-thirds of the additional cost of providing benefits. In high-layoff sectors like construction, companies pay, on average, less than a third of the extra costs generated by layoffs.

As a consequence, many companies are, in effect, subsidized when they lay off workers. In an era when rapid technological change enables companies to lay off workers and increase profitability, imperfect experience rating is even less defensible.

Experience rating stabilizes employment. When Washington State instituted experience rating in response to federal incentives in 1985, employers became less likely to lay off workers than were their counterparts in Oregon and Idaho, according to a study just published in The Journal of Public Economics by Patricia Anderson of Dartmouth and Bruce D. Meyer of Northwestern.

Another study in the same journal, by Professor Levine and David Card of the University of California at Berkeley, estimates that the unemployment rate would decline by six-tenths of a percentage point if industries were fully experience rated -- that is, if employers in an industry were required to pay the full additional costs of unemployment benefits for layoffs in that industry.

The federal government sets minimum standards for state unemployment insurance programs and has a history of encouraging experience rating. This arrangement has worked well for more than half a century and should not be changed in the rush to devolve federal programs to the states.

To shore up the system, states could be required to improve experience rating and maintain adequate trust fund balances. This could be accomplished by increasing the 5.4 percent maximum tax rate on high-layoff employers. In addition, the per employee taxable earnings cap -- $7,000 to $10,000 in most states -- should be raised, which would allow better experience rating at lower tax rates and increase demand for lower-paid workers.

If President-elect George W. Bush is serious when he says that he and his advisers are focusing on bad economic news to be prepared in case of a recession, they would do well to cast an eye toward the state of unemployment insurance funds and improve experience rating