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of the House Committee on Ways and Means

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During the hearing on Increasing Economic Security for American Workers on Thursday, March 15, 2007, Mr. Weller asked for responses to questions posed in the written testimony of Thea Lee. My responses to these questions are provided below, assuming that the wage insurance program is structured as in the draft Worker Empowerment Act provided to witnesses for review.

Responses to questions

- To what extent would a universal wage insurance program shorten unemployment spells?

The introduction of wage insurance is anticipated to reduce unemployment duration for those with wage losses by a small amount. The incentives for shorter duration are two-fold. First, the wage of the new job is higher with wage insurance, making work more attractive than it is without wage insurance. Second, the amount of time during which a worker can collect wage insurance decreases for each day since the job loss that a new job is not found.

There is, however, a counter-acting incentive that total annual income is higher with wage insurance, which can motivate longer unemployment spells in some cases. For example, without wage insurance a worker previously earnings \$42,000 per year may take a new job at \$30,000 per year immediately after job loss in order to ensure making a minimum annual income (say, to pay a mortgage). If the worker has wage insurance, however, and is confident that a “fall-back” job at \$30,000 per year will be available throughout the first several months after job loss, she can afford to search for up to two months for an alternative and still have at least \$30,000 in income during the first year after job loss (with \$25,000 in earnings from ten months of employment on the fall-back job plus \$5,000 in wage insurance).

The evidence from the Canadian Earnings Supplement Project is the most directly relevant to this question, as it provided a form of wage insurance (although not exactly the same as that being considered in the U.S., as it had a requirement of finding a new job within 26 weeks, 75 percent earnings replacement, more generous unemployment insurance benefits, etc.). This project found that unemployment durations were reduced slightly, but not significantly. There was a significant increase in the percentage working full-time 26 weeks after job loss, likely driven by that program’s requirement to have full-time work within 26 weeks in order to qualify for the wage supplement payments. A substantial part of this increase involved switching from part-time to full-time work and it was not comprised solely of switching from unemployment to full-time work.

- To what extent would a universal wage insurance program induce workers to accept lower-wage employment they might otherwise refuse?

There is evidence that when searching for a job, the unemployed place emphasis not only on the current market valuation of their skills, but also on how wage offers compare to their previous wages. The availability of wage insurance may help people overcome this psychological hurdle and more quickly accept prevailing market wages. This may also help avoid prolonged unemployment that can further depress wage offers – such as when longer duration is perceived as a negative signal by employers, when individuals become discouraged and reduce search effort, or when their skills deteriorate.

Evidence from tax rate changes and from demonstration projects including the negative income tax experiments and the Canadian Earnings Supplement Project do not provide significant evidence suggesting the availability of wage insurance payments would lead individuals to choose jobs with lower wages than they would in the absence of wage insurance.

- Would these lower-paying jobs lack benefits such as health insurance?

The formulation of wage insurance in the Worker Empowerment Act actually creates incentives for workers to prefer a mix of total compensation that includes relatively more fringe benefits in exchange for lower gross wages. For example, a worker earning previously earning \$70,000 may be equally happy with a job paying \$70,000 without employer-provided health insurance or with a new job paying \$60,000 with the employer providing health insurance having post-tax value of \$10,000. If wage insurance were available, the worker would prefer the job providing health insurance. While lower-wage jobs are less likely to offer health insurance in general, beneficiaries of the Worker Empowerment Act will tend to disproportionately seek out those jobs that do offer health insurance.

- What portion of wage subsidy recipients would have taken lower-paying jobs even without the subsidy?

According to the Displaced Workers Survey, one-fourth of those permanently laid off in 2002 had wages at least 25 percent lower than their previous job without any wage insurance.¹

- To what extent would the employment of wage-subsidized workers displace other workers?

If unemployment durations for those with wage losses decrease as anticipated, then unemployment durations for others with skills similar to displaced workers (such as new labor market entrants) may increase, but total unemployment duration of all groups combined is anticipated to decrease. With increased search intensity among those with wage losses, the total

¹ Kling, Jeffrey R. “Fundamentally Restructuring Unemployment Insurance: Wage-loss Insurance and Temporary Earnings Replacement Accounts.” Hamilton Project Discussion Paper 2006-05, September 2006. <http://www3.brookings.edu/views/papers/200609kling.pdf>

number of jobs and the total output of the economy are likely to be higher, with this increased economic growth reducing any impact on the unemployment durations of other groups.

Davidson and Woodbury (1995) conducted a simulation of what might happen if wage insurance were introduced into their model of the economy, but there is no actual empirical evidence of any impacts on non-recipients of wage insurance.² Davidson and Woodbury claim that virtually all the employment gains experienced by dislocated workers as a result of the wage subsidy come at the expense of other workers. This claim comes about largely because the simulation in this study assumes the number of jobs is fixed and there is not any economic growth induced by the increase in work from the wage subsidy. The authors wrote that: “Other groups of workers could experience small increases in unemployment duration, and decreases in employment levels that almost fully offset the gains for dislocated workers. ... the crowding-out results are quite sensitive to one of our assumptions ... that the total number of available jobs (T) is fixed.” The assumption of no economic growth is unlikely to hold true in practice.

- To what extent would employers provide subsidized workers with on-the-job training?

If wage insurance is offered for a specific time period, such as two years as in the draft Worker Empowerment Act, there is an incentive for firms to offer more jobs that have lower initial earnings that would rise more rapidly over time than in the absence of wage insurance. In order for workers to accept offers of lower initial earnings (in the absence of a credible long-term contract), the firm would need to offer some incentive to the workers (such as on-the-job training) that would reassure the worker that the firm will want to retain them at higher wages in the future.³ This training would most likely be firm-specific, since otherwise the firm would tend to avoid training for fear of losing its investment in the worker’s training if the worker left the firm.

² Davidson, Carl and Stephen A. Woodbury. “Wage-Rate Subsidies for Dislocated Workers.” Upjohn Institute Staff Working Paper 95-31, January 1995 <http://www.upjohninstitute.org/publications/wp/95-31.pdf>

The wage-loss replacement rate is one-half, and the duration is up to two years in this simulation. They write that “The results suggest that a wage-rate subsidy paid for two years after reemployment would shorten the unemployment spells of dislocated workers by nearly 2 weeks, and would increase employment of dislocated workers by about 900 to 1000 per 100,000 in the labor force. But the simulations also raise the possibility that the gains for dislocated workers could come at the expense of other groups of workers; that is, other groups of workers could experience small increases in unemployment duration, and decreases in employment levels that almost fully offset the gains for dislocated workers. Three factors may mitigate these crowding-out results -- crowding out is widely dispersed over various groups of non-dislocated workers, the structural changes that result in dislocation of some workers (and drive the need for a policy like a wage subsidy) benefit non-dislocated workers, and the crowding-out results are quite sensitive to one of our assumptions ... that the total number of available jobs (T) is fixed and exogenous.” That is, the simulation assumes there cannot be any economic growth.

³ In September 2006, I wrote that the impact of wage insurance “on types of jobs and on associated on-the-job training is likely to be negligible.” The analysis in this section is more recent and reflects my updated thinking on this topic.

- To what extent would any on-the-job training given by employers provide transferable skills?

In addition to training of workers receiving wage insurance, the existence of wage insurance is also an incentive for firms to offer more firm-specific on-the-job training to all workers. In choosing between a higher-wage job with firm-specific skills or a lower-wage job with transferable skills, the higher-wage job is more attractive to workers when there is wage insurance to help insure against the loss in the event of a layoff of higher wages that are firm-specific. Rather than through on-the-job training, wage insurance would be most likely to provide transferable skills in a situation where the wage insurance payments were used by a worker to attend a community college class providing general skills.

- To what extent would a large-scale universal wage insurance program subsidize low-wage employers such as Wal-Mart?

It would be difficult in most cases for an employer to game the system by paying a worker an artificially low hourly wage in order to increase wage insurance payments, because some of the firm's new hires would not be displaced workers and two pay rates would be needed for the same type of work. The gaming would be perceived as inequitable, transparently visible to many employees, and easily auditable if investigated. This is especially true in a large firm with a human resources department and established position descriptions and pay scales.

- To what extent would employers be able to capture the subsidy by paying subsidized workers less than they would otherwise?

If a firm did offer wages to a wage insurance recipient that were lower than their productivity value, another firm would have an incentive to pay a higher wage and hire that worker. In the absence of collusion by firms, it would not be sustainable for firms to attract workers by offering wages that were lower than their productivity value.

- To what extent would wage subsidies lower wages for non-recipients?

Increases in total labor supply from increased search intensity due to wage insurance may reduce wage levels, in the same manner as any other policy that successfully encourages work. The effect on labor supply is likely to be small, and the effect on wages is likely to be small in magnitude as well. Any effect on wages from increased labor supply would be an outcome for the entire market and would not be an employer capturing a government subsidy for themselves. In the presence of wage insurance, firms may offer more firm-specific training (with lower initial wages but higher average wages), or may also offer new higher-paying jobs with a greater chance of layoff that were not previously offered. These factors could offset or exceed the effect of increased labor supply and potentially lead to higher wages for non-recipients -- although the average effect on overall wages is likely to be small either way.

- To what extent would the availability of a program designed to promote “rapid reemployment” – such as wage insurance – be used as an argument against strengthening programs serving displaced workers that have historically been attacked for prolonging unemployment? To what extent would it enable critics of programs serving displaced workers to make them less accessible or less attractive?

These final two questions posed appear to be outside the scope of economic analysis, and no responses are provided here.

Other comments

I recommend making some modifications to the draft Worker Empowerment Act (WEA).

- Introduce a gradual phase-out.

In WEA, someone whose old job paid \$120,000 and whose new job paid \$100,000 would receive \$10,000 a year. If the new job paid \$101,000, they would receive no wage insurance at all. This abrupt phase-out is inequitable, and has incentives for individuals to prefer lower earnings in the range from \$100,000 to \$110,000.

I recommend removing the eligibility criterion of earning not more than \$100,000 per year, and replacing this with a gradual phase-out. One simple method of implementing a phase-out would be to determine the wage insurance payment based on an “insured wage” instead of the pre-separation wage alone. The insured wage would be the lower of the wages on the old job or some maximum value, such as \$110,000.

Setting the maximum value of the insured wage involves a trade-off between inclusiveness of a program and the targeting of resources to those who have the greatest need. The use of \$110,000 as the maximum value would be consistent with the WEA’s current formulation as it pays no benefits to those whose new job pays \$110,000 and full benefits to those whose new job pays \$90,000.

- Make the cap on payments monthly.

WEA includes a maximum payment of \$10,000 per year in each of the two years since separation from the employer. This cap could have some unintended effects for those with very large wage losses. For example, if an old job was \$220,000 per year and a new job was \$100,000 per year, then a worker could be unemployed for ten months, work two months earning \$16,667, and also earn \$10,000 in wage insurance for those two months. Since payments are to be made on at least a monthly basis, these unintended effects could be avoided by capping the maximum payment at \$833 per month (and could still be accurately described as a \$10,000 per year cap).

- Allow flexibility in the calculation methods for pre-separation wages.

In WEA, the wages received by an individual at the time of separation shall be computed based on the wages received by such individual for the 52-week period ending before the date of separation. It may be dramatically simpler to use the calendar quarter of separation and the preceding three calendar quarters, since all firms are filing reports on earnings on a calendar quarter basis.

- Allow flexibility in the calculation methods for pre-separation hours.

In WEA, an individual is eligible for benefits if she is reemployed for substantially the same number of hours each pay period as at the time of separation. There are likely to be considerable advantages in using a requirement such as “reemployed for substantially the same number of hours per week during the payment period as during the period used to calculate pre-separation wages.” This would clarify that “at the time of separation” does not mean the hours worked in the single pay period prior to separation, which might not be representative of the period over which pre-separation wages were calculated. Moreover, the hours each pay period will necessarily differ for pay periods of different length, and the pay period duration may vary on the old and new jobs.

- Allow flexibility to potentially incorporate the value of fringe benefits into pre-separation compensation and post-separation compensation.

The underlying principle of wage insurance is to provide a supplemental payment when the compensation on a new job is lower than the compensation on a job from which there was an involuntary separation. When wage insurance payments are based on gross wages, there can be some unintended consequences. For example, a worker previously earning \$70,000 with employer-provided health insurance having post-tax value of \$10,000 taking a new job paying \$70,000 without employer-provided health insurance is clearly worse off, but receives no wage insurance. Conversely, a worker previously earning \$70,000 without employer-provided health insurance taking a new job paying \$65,000 with employer-provided health insurance having post-tax value of \$10,000 is better off, but does receive wage insurance. The extent of these unintended consequences could be reduced if the value of fringe benefits were included in the calculation of pre-separation wages and post-separation compensation.