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of the House Committee on Ways and Means

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Chairman McDermott, Representative Weller, and members of the Subcommittee, thank you for the opportunity to testify at this hearing on Unemployment Insurance (UI) modernization. I fully support the efforts of this committee to modernize UI. Improving coverage for low-wage and part-time workers, making UI more family friendly, and improving skills are all worthy endeavors. But I also believe that there are higher priorities for modernization than those addressed in the Unemployment Insurance Modernization Act. The main themes of my remarks are these:

- The modern UI system should focus more on the larger, longer-term consequences of job loss.
- This reorientation will ultimately require a much more ambitious set of UI reforms.
- The current agenda should include measures that lay the groundwork for these more fundamental reforms.

**Focusing on larger, longer-term consequences of unemployment**

In looking toward the future of a modern system, we must have clear goals. In 1936, the federal government powerfully articulated what I believe to be the key goal of unemployment insurance: "to lighten the burden which now so often falls with crushing force upon the unemployed worker and his family."[1]

Seventy years later, the nature of this crushing force has changed. Maintaining living standards immediately after job loss, the original focus of UI, is no longer the major difficulty associated with unemployment. In the twenty-first century economy, the situation has changed in at least three key ways. First, job loss is now more likely to be permanent, and associated with drops in long-term wages, not just short-term income loss. Second, unemployment duration has increased. Third, people have greater ability to borrow to tide over short periods of unemployment. These three facts – more permanent job loss with large wage losses, longer unemployment durations, and greater ability to borrow – suggest a shift in resources towards larger, longer-term consequences of unemployment should be the top priority of efforts to modernize the UI system.

The most effective way to target long-term losses is to implement a wage-loss insurance system similar to that recently proposed by H.R. 2202, the Worker Empowerment Act, introduced by

[1] Advisory Commission on Unemployment Compensation. *Unemployment Insurance in the United States*: *Benefits, Financing, Coverage.* Washington, DC, 1995. (Quoting a statement by the U.S. Social Security Board in 1936.)

Chairman McDermott, where a fraction of the difference in wages between an old and new job is paid for a period of years. A wage-loss insurance system can better target the largest losses while simultaneously providing more benefits to the lower half of the income distribution. It would also be valuable to improve the mechanisms that trigger extended benefit payments for those with longer-term unemployment spells. These benefits could be triggered more frequently, and the durations could be modulated to last for shorter or longer amounts of time.

Smaller, shorter-term consequences of unemployment could be managed in ways other than with UI benefits. Increasing the number of waiting weeks before UI benefits begin or establishing personal accounts from which one could borrow and repay from future earnings are two possible mechanisms for directing UI resources towards larger, longer-term losses. These approaches would also promote re-employment by removing the incentive to stay unemployed that is created by UI benefit receipt. My analysis of studies of the responsiveness of unemployment spells to UI benefits suggest that unemployment durations would decline by 10 to 15 percent if UI benefits were fully replaced at some point by personal accounts. These accounts, along with forgivable loans, could ensure the maintenance of living standards during the first six months after job loss at a level equal to that under the current UI system.[2] Once mechanisms for supporting living standards are in place, the key issue is how to target insurance to those with the largest long-term losses. I have found that only one-third of unemployment insurance benefit payments currently go to those who subsequently have lower wages over the ten years after job loss. We can do better than that.

I have submitted written testimony which makes three additional points about modernizing UI:

- The payroll tax base for UI should be broader.
- Compensation insured by UI should include the value of major employer benefits.
- A system of temporary earnings replacement accounts and wage-loss insurance is feasible for the future, and its components merit demonstration and evaluation.

Even if the focus of the UI Modernization Act remains on broadening eligibility and other issues currently envisioned, additional provisions could be added to begin to explore the fundamental modernization I have described today. It would be extremely beneficial to facilitate experimentation by states interested in focusing on larger, longer-term losses, payroll tax base broadening, incorporation of employer-provided benefits, or other priority areas for modernization. Just 2 percent of funds in the UI Modernization Act would provide $140 million of investment in testing new ideas now that could provide valuable guidance for major decisions about fundamental modernization in the future.

I would welcome further discussion on any of these issues. Thank you.

[2] Kling, Jeffrey R. "Fundamentally Restructuring Unemployment Insurance: Wage-loss Insurance and Temporary Earnings Replacement Accounts." Hamilton Project Discussion Paper 2006-05, September 2006.

UI is the primary form of insurance for job loss in our country. The basic structure of our UI system has remained essentially the same since it was established 70 years ago. Our economy, however, has changed a great deal over this time, creating a need for modernization.[3]

Today more job losses are permanent and more unemployment spells are long ones. For instance, looking at similar points in the business cycle of 1961 and 2002, the percentage of UI recipients exhausting their benefits (often after 26 weeks of unemployment) increased from 30 percent to 43 percent.[4] Perhaps most importantly, many workers can find new jobs only at reduced wages. In 2002 over one-fourth of job losers had earnings losses of 25 percent or more eighteen months after the job loss.[5] It is the devastation of permanent income declines after job loss is that is the crushing force of unemployment in today's economy.

Meanwhile, financial innovations ranging from credit cards to home equity loans have made it possible for many individuals to borrow funds to maintain living standards in the weeks immediately after job loss. For example, the first credit cards were issued in 1951. By 1983, over one-third of lower-income households (and about two-thirds of UI recipients) had at least one credit card; by 2001, over one-half of lower-income households (and about three-quarters of UI recipients) had a credit card.[6] Since it is increasingly feasible to borrow during unemployment, larger UI payments could be targeted to those who will have difficulty in repaying, rather than spending UI resources on those who have an unemployment spell and go on to have higher income than prior to job loss.

## Broadening the payroll tax base for UI

In 1937, the maximum amount of taxable earnings for Social Security and for UI both was $3000. Today the taxable earnings base for Social Security is $97,500, while the taxable base for UI is $7000. The narrow earnings base for UI translates into high tax rates for low earners.[7] The UI tax rate is over 2.5 percent for the bottom quarter of the wage distribution and less than 1 percent for the top quarter of the wage distribution. Shifting from the current earnings base to the Social Security earnings base could collect the same amount of revenue while allowing tax rates to fall. The tax rate on the bottom quarter of the wage distribution could be cut approximately in half, making the tax much less regressive. The UI taxable wage base has not increased since

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[3] For an overview, see Stone, Chad, Robert Greenstein, and Martha Coven, "Addressing Longstanding Gaps in Unemployment Insurance Coverage." Center on Budget and Policy Priorities (August 7, 2007). http://www.cbpp.org/7-20-07ui.pdf

[4] http://workforcesecurity.doleta.gov/unemploy/hb394.as (accessed September 17, 2007)

[5] Kling (2006).

[6] The percentage of households in the lowest third of the income distribution with a head younger than 60 where someone in the household has a credit card was 34 percent in 1983 and 54 percent in 2001. The percentage of households receiving unemployment insurance or worker's compensation with a head younger than 60 where someone in the household has a credit card was 65 percent in 1983 and 76 percent in 2001. (Karen Dynan, personal communication, September 17, 2007).

[7] Anderson, Patricia M., and Bruce D. Meyer. Unemployment insurance tax burdens and benefits: Funding family leave and reforming the payroll tax. *National Tax Journal* 59:1 (2006), 77–95.

1983; it is one of the features most in need of modernization and would be relatively simple to address. Leadership by the federal government would likely motivate states to make adjustments as well.

Regarding UI taxes, note that my recommendations for modernizing the UI system are not at all contingent upon whether the temporary FUTA surtax is extended. In past hearings before this committee I have observed the testimony from witnesses degenerate into discussion of a change in tax revenue. However, an order of magnitude more is being spent on the underlying program itself, and opportunities to engage in public discourse about the fundamental structure of the unemployment insurance system have been missed. Even if large-scale changes are not feasible at this moment in time, there are things we can and should do now to set the stage for making informed choices about fundamental modernization in the future.

**Compensation insured by UI should include the value of major employer benefits**

In 1950, pension and health plans were about 3 percent of total compensation; in 2006, employer contributions to pension and health plans had increased to 15 percent of total compensation.[8] When an individual loses a job however, these contributions are lost. Moreover, UI benefits are based on earnings, and do not incorporate the value of these employer contributions. Partly as a result, the loss of health insurance can be a particularly difficult aspect of unemployment.

The rising importance of fringe benefits over time has not been incorporated into the UI system, and their incorporation would be a valuable addition to a modernized system. Employers could include pension contributions and the per-employee costs of employer provided health benefits in quarterly reports of compensation. States could then either collect more revenue and increase outlays based on the total compensation (which would be higher than earnings alone) or adjust their tax rates and outlays to reach desired targets.

**Temporary earnings replacement accounts and wage-loss insurance**

In recent work I have discussed issues involved with a fundamental shift toward insurance for persistent, long-term effects of job loss, based on the core principle that smaller, short-term needs can be met through savings, borrowing, and repayment, so that the funds for insurance can be targeted to assist those facing larger, longer-term losses.[9] This is not a change that I recommend making immediately, but it outlines a direction for modernization that suggests key issues that merit exploration, experimentation, and demonstration.

In the remainder of this section, I outline what would be involved in creating a future system where two-thirds of the financial resources currently used for UI would be shifted to wage-loss insurance to augment the hourly wages of individuals who find new jobs at wages lower than their previous jobs. Temporary Earnings Replacement Accounts (TERAs) would provide the same amount of cash as under UI to be withdrawn during unemployment. Unemployment would

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[8] Gary Burtless, personal communication, September 15, 2007.
[9] This section draws upon Kling (2006).

be reduced by removing subsidies for temporary layoffs and by creating stronger incentives to return to work. The proposed system would provide a significantly greater share of net program benefits to workers in the lower half of the income distribution when compared to the current system of UI benefits alone. By targeting system resources to those whose hourly wages are lower on their new jobs after an involuntary job loss, significant hardship would be reduced.

To compare current UI with this proposed modernization in the context of a concrete example, consider an aircraft assembly employee in California who was making $14 per hour and working 40 hours per week before her plant closed and she was laid off. If she were to apply for UI under the existing system, the state would check to see that she worked for an employer covered by UI, that her earnings in the past year were above a threshold, that her employment was terminated involuntarily, and that she is available now to work. When verified as eligible, she would receive benefits replacing half of her income—in this case, $280 per week. Benefits are financed by a payroll tax on the wages paid to employees at all covered firms, with the firm's tax rate depending in part on the amount of UI benefits paid to former employees of the firm. Payroll taxes from firms are paid to the government, and the government pays UI benefits to eligible individuals. The workings of the proposal are illustrated by continuing with this example, first taking the viewpoint of the individual, then the firm, and then the government.

From the individual's viewpoint, during the course of her 10 years of employment at the firm, the worker voluntarily contributed $2,000 to her TERA. (The default on initial employment was a payroll deduction of 1 percent of pretax earnings contributed to her TERA, and she did not opt out of this contribution schedule.) The account was maintained by the government, and her investments were in government bonds. Funds in the account were excluded from asset tests for Food Stamps, Medicaid, and other government programs, so they did not reduce any potential eligibility for assistance from these programs.

After being laid off from her aircraft assembly job, she could apply to receive the same amount of income as under UI—$280 per week, replacing half of her previous earnings. This amount is treated as taxable income as it would have been under current UI. The eligibility criteria would also be the same as under UI. The difference is that the funds would come from a combination of previously accumulated savings in the TERA and borrowing against future employment income. Say that she remains unemployed for 10 weeks, receiving $2,800. She thus draws down the $2,000 in her TERA and borrows an additional $800, leaving her TERA balance at negative $800. She then takes a new job that pays $10 per hour. Her new firm deducts 5 percent of her earnings from her paycheck until she has repaid the $800 (plus interest).

The proposal's other main component involves wage-loss insurance. To be eligible for wage-loss insurance payments, a period of unemployment between the involuntary job loss and the next job would not be required, but all other requirements for initial UI eligibility, such as requirements regarding earnings history and nature of the job loss, would still need to be met. In addition, wage-loss insurance would be available only to those with at least one year of tenure with their previous employer; obviously, individuals would need to have taken a new job with a different employer. The amount of the wage-loss insurance per hour worked on the new job would be based on an insured wage rate—either the wage on the previous job or the fixed amount of $15 per hour, whichever is lower—and calculated as 25 percent of the difference between the insured

wage rate and the hourly rate on the new job. The insured wage for each individual would be adjusted each quarter for price inflation, as would the level (initially at $15) of the fixed maximum potential insured wage for future claimants and other parameters of the system based on dollar values.

In this example, the aircraft assembly worker experiences a $4 per hour reduction in wages ($14 per hour at the previous job, $10 per hour at the new one). Assuming no inflation, her wage-loss insurance payments are 25 percent of this $4 reduction—in other words, the wage-loss insurance payment amounts to $1 per hour. These payments are initially deposited directly in her TERA. They would be used first to repay her incurred $800 loan, which would take about 14 weeks of work at the new job. She would then receive the wage-loss insurance payments for six years, which is a period based on total hours of work in her two years prior to job loss (three hours of insurance coverage for each hour worked, excluding hours worked in the first year on the job). After her TERA balance reached a maximum threshold ($5,000), additional payments from wage-loss insurance would be sent to her by check. Assuming her wage rate did not change, her income drop would be reduced from 28 percent (based on labor earnings falling from $14 to $10 per hour) to 21 percent (including the $1 per hour insurance payment) over the six years she receives payments. If her wage in the new job did rise or fall, the wage-loss insurance payments would be adjusted as well, so that the wage-loss insurance payments in each calendar quarter would be based on the average hourly wage since job loss through that quarter.

The amounts of transfer payments would vary with individual circumstances. Generally speaking, transfer payments to individuals would be smaller under this proposal than they would be under traditional UI for those experiencing unemployment spells followed by employment at wages the same or higher than at the time of layoff. Transfer payments would be the same to minimum wage workers and those who never return to work following a period of unemployment, and transfer payments would be larger after permanent job loss for those working at a new job with a lower hourly wage.

Four special conditions that don't apply to our hypothetical aircraft assembly worker are worth noting here. First, those with very low wages on their previous job would receive supplemental assistance if they needed to borrow funds from their TERA. The members of this group are unlikely to benefit much from wage-loss insurance because the wages of their previous jobs were already so low, limiting their potential wage losses at new jobs, given minimum wage laws. The coinsurance rate for this supplemental assistance would run on a sliding scale, such that someone earning $5.15 per hour would not have to repay any borrowing from the TERA—but also would not receive any wage-loss insurance payments. Such a worker would be in exactly the same position under current UI and under the proposed system.

Second, if our hypothetical worker reached retirement age and filed for Social Security benefits, any positive balance remaining in her TERA would be transferred to an Individual Retirement Account (IRA) for her. If her earnings had been too low to repay any loans from her TERA at the point she would begin collecting Social Security, then TERA repayment insurance would pay off the remaining balance.

Third, if she had opted out of making payroll contributions to her TERA, instead of accepting the default option of making such contributions, her withdrawals during unemployment would have been entirely a loan from her TERA, which she would repay with interest through deductions from paychecks at her new job.

Fourth, if she held two or more jobs with separate employers, each job would be separately insured. Withdrawal amounts would be based on earnings at the specific job that was lost, and the insured wage for wage-loss insurance would be set based on earnings and hours on the lost job. A new job started a week before being laid off from one's main job and a job started a week after a layoff would be treated the same way for the purposes of wage-loss insurance eligibility and payments, with calculation of the post–job loss hourly wage beginning in the calendar quarter after job loss.

From the firm's viewpoint, the aircraft-manufacturing firm laying off the individual in the example would submit three types of payments to the government over time. Initially, the firm would send payroll deductions for voluntary saving to the TERA; these deductions reflect contributions made by workers who do not opt out of the default saving mechanism for the TERAs. Taxes based on the firm's payroll, as under the current UI, would support the administration of the system and finance two types of payments: repayment insurance to pay off loans for individuals who retire but who had earnings too low to fully repay their TERA withdrawals, and low-wage coinsurance to reduce potential TERA repayments for those with low hourly wages.

Regarding the flow of funds for wage-loss insurance, firms would reimburse the government for wage-loss insurance claims of former employees, and the government would pay the employees. Firms would also be required to purchase insurance on the private market to cover wage-loss insurance claims in the event that the firm became insolvent, and the insurer would then make payments to the government in the event of firm insolvency.

In total, firms would make payments to the government for wage-loss insurance, repayment insurance, assistance on TERA repayments for those with low wages, and other costs of the proposed system that would be approximately the same as the current UI system. In terms of funds currently paid in UI benefits, nearly two-thirds of the money would be reallocated to wage-loss insurance, about 30 percent would go to repayment insurance, and 6 percent would be used for supplemental assistance for TERA withdrawals by those with wages near the minimum wage. Thus, revenue from new payments for wage-loss insurance reimbursement would combine with reduced revenue from the payroll tax so that a change to the proposed system would be revenue neutral.

The UI taxable earnings base would be increased from the current caps (e.g., 27 states had caps on taxable earnings of $10,000 or less in 2005) to the Social Security earnings base (which was $90,000 for 2005, and which increases annually with the national wage index). The reduced revenue needs from the UI payroll tax combined with the broader tax base would allow average payroll tax rates to be substantially reduced. UI tax rates would continue to vary by firm as under traditional UI (according to previous use of TERAs by former employees, as opposed to previous payments of UI benefits to former employees). These rates would be more tightly linked to firm

layoff histories through the combination of lower average tax rates and a lowering of the minimum rates that states require firms to pay. Since firm-varying rates would be less constrained by the floors and ceilings that characterize the current system, firms that lay off workers would see higher UI payroll taxes in the future.

A firm that hired a previously unemployed worker would carry out mandatory payroll deductions for repayment of loans when that employee's TERA withdrawals had resulted in negative TERA balances. Such deductions would appear on pay stubs as pretax deductions, similar to health insurance, retirement plans, and dependent care expense accounts.

From the government's viewpoint, UI is run under current law by the states under the oversight of the federal government, and this pattern would remain in place under this proposal. States would continue to be responsible for verifying a person's eligibility for unemployment benefits. States would also determine how much each unemployed person could withdraw from his or her TERA per week. States would continue to collect payroll taxes, which would be used for TERA repayment insurance and low-wage coinsurance.

The flows of funds to the government from firms and insurers and from the government to individuals would involve individuals making TERA withdrawals and receive wage-loss insurance payments. It is sometimes proposed that a minimum size should be set for the level of payments because, for example, very small wage losses could lead to very small payments. However, once an employee has borrowed from a TERA and the wage-loss insurance program has been established, the administrative cost of making these payments would be very low. Once a claim has been approved, benefit amount determination and deposits can essentially be automatic, based on employer reports of earnings and hours for each quarter.

The federal government would manage the TERAs in this system. The government can take advantage of economies of scale to keep costs low, and it can avoid TERA transfers when individuals change employers or move across state lines. The interest rate on government bonds would be the rate of interest required for repayment of borrowed funds.

Funds in the TERAs would be invested and earn a rate of return on positive balances. The automatic default investment would be in government bonds. Such a safe default investment seems appropriate given that job loss is an unpredictable event and the savings may be needed at any time. For positive TERA balances, workers could opt into a portfolio with a mixture of stocks and bonds, where the portfolio composition varied depending on the retirement age of individual, modeled on the federal Thrift Savings Plan's life-cycle funds. Changes from bonds to life-cycle funds would be allowed once per calendar quarter.

The federal government would also have the power to authorize extending the standard 26-week period in which the unemployed person can make withdrawals from a TERA, just as the federal government now can extend eligibility for unemployment benefits when the economy is in or near a recession. During the extended period, individuals could continue to make withdrawals and borrow from their TERAs. Firms would not have their future payroll tax rates increased because of withdrawals during the extended period. Federal unemployment taxes would contribute to the repayment insurance that would cover borrowed funds that were not repaid.

The transition to a system of TERAs and wage-loss insurance would phase in naturally. In the first year of the program, firms would be charged the full amount of withdrawals by their former employees from TERAs because the former employees would initially have no savings and the system would need funds to loan out from TERAs. Wage-loss insurance payments would not be paid in the first year, however, so total outlays by firms would not increase.

In the second year of the program, some workers would begin to qualify for wage-loss insurance and firms would begin to make wage-loss insurance reimbursement payments to the government. The parameters of the system could be set so that the combined cost to firms for TERA withdrawals and wage-loss insurance payments would be no larger than the firms' costs under the current UI system.

The proposal could be adopted by one or more states, while other states could opt to remain with the existing system. Coverage for compensation after involuntary job loss would be determined by the location of the employing establishment at the time of job loss, just as under the traditional UI system. Individuals who worked in a state adopting this proposal would be covered under it even if they relocated to a state that had not adopted this proposal.