

Failures of the Unemployment Insurance System

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June 2011

[Overview](#)
[Origins of Unemployment Insurance](#)
[Structure of the UI System](#)
[Justifications for the UI System](#)
[Problems Caused by Government UI](#)
[Conclusions](#)

Overview

The Social Security Act of 1935 established the federal-state unemployment insurance (UI) system, which pays benefits to workers who are laid off. Basic UI benefits are funded by payroll taxes on employers, but in recent years Congress has used general federal revenues to fund a range of extra benefits.

With the recent recession and stagnant economy, the cost of the UI system has soared. In 2011, the program will cost taxpayers \$134 billion, but the costs are expected to decline in coming years as the economy recovers.¹ Note that "unemployment insurance" and "unemployment compensation" are used interchangeably in referring to the system.

This essay describes the origins and structure of the unemployment insurance system. It critiques the justifications given for government-run UI, and it discusses the economic distortions caused by the system. The UI system raises the cost of hiring, creates a disincentive to work, reduces the incentive to save, and subsidizes some businesses and workers at the expense of others.

One reform option would be to switch to a system based on personal UI savings accounts, as the nation of Chile has done. Another option would be for the federal government to fully devolve UI to the state level. If the states financed and administered their own systems, they could more easily pursue innovations to reduce the costs and distortions caused by the current UI structure.

Origins of Unemployment Insurance

A number of industrial countries enacted national unemployment insurance programs in the early 20th century, including Britain in 1911, Italy in 1919, and Germany in 1927.² In the United States, unemployment insurance attracted some interest, and a President's Conference on Unemployment in 1921 prompted an examination of the matter.³ However, there was a strong presumption in America, prior to the Great Depression, that private-sector efforts should be at the forefront of solving the problem of unemployed workers. It was also generally assumed that federal intervention to create a UI program would be unconstitutional.

Numerous U.S. labor unions, such as the Cigarmakers' International, already offered their own out-of-work benefits, as did most British labor unions before that country's government system was enacted.⁴ In 1910, nearly 30 percent of total union expenditures in Britain went toward out-of-work benefits.⁵ Some U.S. manufacturing companies offered unemployment benefits, and there were a number of plans offered jointly by businesses and unions, such as those in the clothing and garment industries. There was also growing interest among private insurance companies to introduce unemployment plans to the general public.

Many leaders of the labor movement at the time were against government unemployment insurance, including Samuel Gompers, head of the American Federation of Labor (AFL). Here's what Gompers said at a 1921 AFL conference:

If we should establish the so-called unemployment insurance, every action of our life, insofar as it refers to labor and employment, would be subject to the regulation and the discipline and decision of government ... The whole activity to organize, to assert and to live our own lives would be subject to every petty or high official of the government.⁶

Gompers feared that government UI would encourage broader federal intrusion into the activities of labor unions and workers. Also, union organizations were strengthened when they offered their own unemployment insurance plans, and thus they were concerned that a new government system would reduce their relevance.⁷

In sum, there was no strong movement in favor of a federal UI program prior to the 1930s. Most policymakers thought that Washington had no constitutional authority to enact an UI plan, and numerous union leaders were against it. At the same time, there were increasing efforts by industrial companies, unions, and insurance companies to create private solutions to the problem of income support during unemployment.

There was greater support for government UI at the state level. Dozens of bills to create UI schemes were introduced in state legislatures in the 1920s, although these initiatives were defeated. Some state legislators opposed legislation because they thought that UI was not a proper function of government, and others opposed it because they didn't want to put their state at a business disadvantage compared to

other states. The first state UI law was enacted in Wisconsin in 1932.⁸

The Great Depression greatly changed the political environment. With unemployment reaching high levels, federal policymakers began creating programs to lessen the economic hardships. The Social Security Act of 1935 included a plan for a federal-state unemployment insurance (or unemployment compensation) program. The dual goals of the UI program were to provide a safety net to workers who became involuntarily unemployed and to help stabilize the overall economy during downturns.

Why weren't proponents of government UI content with trying to enact their systems at the state level? Proponents wanted a national system in order to quell interstate business competition, which would be created by different UI tax burdens in each state.⁹ Fiscal conservatives think that such interstate competition is beneficial, but liberals have long pushed to nationalize government activities to reduce the ability of lower-tax states to draw people and businesses from higher-tax states. The UI system enacted in 1935 ended up being a compromise federal-state system.

The system was built around a federal payroll tax that would be mainly rebated to those states that established UI programs conforming to federal guidelines. That created a strong financial incentive for the states to create UI programs—and they all did. The constitutionality of the scheme was promptly challenged, but the Supreme Court narrowly upheld it in the 1937 decision *Steward Machine Company v. Davis* (301 U.S. 548).

Policymakers have expanded unemployment benefits substantially over the decades. Originally, benefits typically lasted 16 weeks, but now the basic benefit period is 26 weeks. In the 1950s and 1960s, temporary laws provided "extended" benefits beyond the basic 26 weeks. Then a 1970 law made extended benefits of 13 weeks a permanent part of the program. In recent decades, Congress has also enacted temporary programs to provide "supplemental" benefits for workers who have exhausted both their basic and extended benefits. In response to the recent recession, Congress passed extraordinary expansions in UI payments such that benefits could be drawn for 99 weeks—or nearly two years—in many states.

Structure of the UI System

Today, the federal government levies a 6.2 percent unemployment insurance tax on the first \$7,000 of each worker's earnings. If a state has established a UI system that meets federal standards (as all have), the federal government credits back 5.4 percent to the states, keeping only 0.8 percent as the net federal tax. In recent years, Congress has also funded extraordinary extensions of UI benefits with general federal revenues.

The net federal payroll tax of 0.8 percent funds

- federal and state administrative costs for the system,
- half of the cost of extended unemployment benefits, and
- loans to state governments when their programs run low on cash.

State payroll taxes fund basic UI benefits and half the cost of extended benefits. Nationwide, UI payroll taxes are expected to raise \$52 billion in 2011.¹⁰

The states have considerable latitude over their UI tax structures, and both tax bases and tax rates vary substantially. Six states impose the UI tax on just the first \$7,000 of wages, which is the federally mandated minimum amount. The rest of the states apply the tax to a larger wage base, with the states of Alaska, Hawaii, Idaho, New Jersey, Oregon, and Washington having the highest wage bases of about \$30,000 or more in 2010.¹¹

The standard UI tax rate in most states is 5.4 percent, but the rate varies by employer depending on the employer's use of the UI system, which is called "experience rating." Companies with more layoffs pay higher UI tax rates and vice versa. In some states, employers can have tax rates as low as zero if they never lay off workers. In other states, tax rates can be as high as 13.5 percent for employers with high layoff rates.¹²

With regard to UI benefits, the states generally set their own parameters for eligibility and benefit amounts. Virtually all wage and salary earners are covered, but self-employed people are outside the system. Workers are generally covered if they are laid off, but not if they quit voluntarily or are fired for cause.

In 2010, the average weekly benefit varied from a high of \$416 in Massachusetts to a low of \$189 in Mississippi.¹³ The weekly benefit amounts across the states replace between about 50 to 70 percent of pretax wages up to a state-determined maximum.¹⁴ The wage-replacement rate is higher for lower-income earners, and the overall average replacement rate is somewhat less than 40 percent.

The extended benefits program provides 13 weeks of benefits in addition to the basic 26 weeks. However, in response to the recent recession, Congress increased the duration of extended benefits and passed various packages of additional increases, with the result that benefits could be drawn for nearly two years in many states. On top of that, the federal government funded an across-the-board increase in benefits of \$25 a week, and it provided the states with billions of dollars of "modernization" funding to induce them to expand their benefit structures.

Justifications for the UI System

Private Safety Nets are Inadequate

There are time-honored ways of protecting oneself against financial hazards in the economy, including insurance policies and personal savings. But since the 1930s, federal policymakers have assumed that such market institutions are inadequate, and they have enacted an

expansive array of government "safety net" programs. Policymakers should reconsider the original assumptions that unemployment insurance was built on. The program was created at a time of unique economic despair in the 1930s, when policymakers thought that private markets had disastrously failed. In fact, damaging government policies played a major role in the economic stagnation of the 1930s.¹⁵ Also, today's economy is dramatically different than the economy at the time when UI was created.

For one thing, average incomes are much higher today than in the 1930s, and most Americans are in a much better position to create their own safety nets through personal savings. There are also more financial vehicles available today for people to use for saving than in the past. Yet in recent decades, the U.S. personal savings rate has plunged. The causes of this decline are much debated, and there seem to be numerous factors at play.

There is little doubt that the expansion in the welfare state has reduced individual incentives for saving. As UI, Social Security, and other programs have grown, people are less inclined to save, and they have less income to do so because of the higher taxes they pay to support the welfare state. One piece of evidence supporting this view is that many fast-growing Asian nations have had very high personal savings rates, which seems to stem partly from the provision of less generous government benefit programs than in North America and Europe.

The growth of government UI in the United States has also eliminated incentives for markets to develop private unemployment insurance. We mentioned that before government UI, many unions in Britain and the United States had established unemployment benefit plans.¹⁶ One UI expert noted, "During times of depression in the late eighteen hundreds and the early part of the nineteen hundreds, practically all trade unions gave assistance to their unemployed members and many unemployment benefit or relief plans sprang up, only to be discontinued when employment conditions improved."¹⁷

A number of major U.S. companies offered unemployment benefits. Between World War I and 1933, firms such as General Electric, Eastman Kodak, Procter and Gamble, and manufacturer J. I. Case established programs. The latter firm, now Case Corporation, had an employee contribution of 5 percent of earnings—matched by the company—until one year's earnings had been accumulated.

There was also growing interest at the time among insurance companies in introducing UI plans to the public. It is true that private UI would face some economic challenges, particularly the problem of "adverse selection."¹⁸ Workers at low risk of unemployment would separate themselves from workers with higher risks and form separate insurance pools, or not buy insurance at all. That would leave higher-risk workers stuck with paying higher—perhaps much higher—premiums.

One market response to this situation would be that workers in more cyclical and risky industries would demand higher compensation. Some people would choose to work in industries with higher chances of layoffs, even without any available insurance, if the pay was right. Indeed, economist Price Fishback notes that in the pre-1935 economy, "workers in industries that suffered from layoffs and unemployment generally received higher wages to compensate for this risk."¹⁹

Legal restrictions have been a hurdle to the development of private UI. Law Professor Michael Rappaport found, for example, that two Michigan insurers profitably sold UI plans beginning as early as 1910, but state law limited their market to just railroad conductors.²⁰ Michigan's prohibition on UI insurance was not unique. In the 25 years prior to the enactment of the UI system in 1935, no state clearly authorized the general sale of UI policies. Rappaport looks at the historical evidence and rejects the view that private unemployment insurance wouldn't work.

Consider the experience of Metropolitan Life. The insurance firm's president, Haley Fiske, was adamant that private UI could be sold. However, Fiske "tried to sell UI almost twenty years before the Social Security Act, but the laws of New York State prohibited its sale."²¹ Fiske's effort to legalize UI policies was opposed in the state legislature by Samuel Gompers, who feared that UI plans would strengthen company unions at the expense of his union. Legislation did finally pass the New York legislature, but it was vetoed by Governor Franklin Roosevelt in 1931, who worried that successful private UI might undermine support for a government UI system.

The story of Metropolitan Life illustrates how innovative companies helped to solve social problems before the creation of the welfare state. In 1909, Met Life established a "Welfare Division," which played a major role in battling tuberculosis. It also created a visiting nurse service to aid its millions of policyholders. The company's website says, "for nearly a half century, approximately 20 million policyholders in more than 7,000 cities and towns in the U.S. and Canada received free nursing care ... policyholders were treated for illnesses such as diphtheria, influenza, smallpox, and tuberculosis."²² Many such entrepreneurial social efforts were pursued before the expansion of the government safety net.

In the 19th century, there were numerous popular movements in America that encouraged savings and thrift.²³ Philanthropists founded "savings banks" to allow moderate-income families to make small deposits. A "school savings bank" movement spread across the country to encourage children to save, which was based on similar movements in Europe. Children were taught about the importance of savings in schools, churches, and youth clubs. The YMCA, the National Education Association, and other groups promoted personal savings. "Moral reformers of the time ... emphasized helping the poor help themselves," and thrift was a central part of the message.²⁴

If the government UI system were repealed, there would be a variety of responses in the marketplace. It is likely that insurance firms would offer UI plans if legal restrictions were removed. It is also likely that individuals would increase their savings rates. Young people would enter the workforce knowing that they needed to save for possible jobless spells. Parents would encourage their children to start saving early. Employers would encourage their employees to save.

A system relying on greater personal saving and private UI would provide a safety net for most people. Such a system couldn't guarantee that no unemployed person ever ran out of money, but neither does the current system. Currently, only a portion of unemployed workers receive UI and benefits are time-limited. So a market-based safety net should not be compared against a utopian system in which no one ever suffers any loss from unemployment.

Harvard University's Martin Feldstein, and other economists, have proposed replacing the current UI system with a system based on personal UI accounts funded by a payroll contribution.²⁵ Savings in the accounts would accumulate over a person's career if not depleted,

and could then be used for retirement expenses. The nation of Chile enacted such personal UI accounts in 2002, and so far they appear to be very successful.²⁶ Personal UI accounts remove the work disincentive created by the current UI system, because people would want to find a new job quickly to preserve their UI account balances. Also, personal UI accounts would have the beneficial side effect of adding to the retirement savings of many workers.

Another reform approach would be to liberalize current Roth individual retirement accounts (IRAs) to allow savings deposits and withdrawals for any reason, including spells of unemployment. Canada instituted such accounts in 2009, which are called Tax-Free Savings Accounts.²⁷ All Canadian residents can contribute up to \$5,000 in after-tax contributions each year. Earnings in the accounts compound tax-free, and withdrawals may be taken for any reason, tax-free. The liberalization of withdrawal rules is a powerful incentive for individuals—especially those with modest incomes—to increase their savings rates.

Economic Stabilization

Since the enactment of unemployment insurance in 1935, proponents have claimed that the system helps to stabilize the economy.²⁸ The theory is that when the economy falls into recession it needs increased consumer spending, which is provided by a surge in benefits to the unemployed. This government spending creates a large multiplier effect on the economy as it boosts aggregate demand, according to economists in the Keynesian tradition.

However, Keynesian macroeconomic theories are subject to a great deal of dispute. Before the 1970s, many economists believed that there was a reliable trade-off between inflation and unemployment. If unemployment were high, the government could simply stimulate aggregate demand to reduce it, although there would be a side effect of modest inflation. The experience of the 1970s curtailed belief in this simplistic Keynesian policy prescription. Government deficit spending ballooned at the time, but that was coincident with both higher inflation and higher unemployment.

These events—and the rise in "monetarist" and "rational expectations" ideas—led most macroeconomists to reject the Keynesian idea that deficit spending could fix recessions. Rational expectations theorists held that people cannot be systematically fooled by the government into taking actions that leave them worse off, as Keynesian theory assumes. If people know that a Keynesian-style stimulus might lead to higher inflation, they will adjust their behavior and the government stimulus will be nullified.

Meanwhile, economists in the Austrian tradition argue that the problem during a recession is not that there is insufficient demand, but that industries need to readjust after monetary manipulations distorted the structure of production. From this perspective, UI does not stabilize the economy, but slows the needed adjustment process by reducing worker incentives to seek employment in other fields. Summarizing the economics profession's move away from Keynesianism, macroeconomist John Cochrane of the [University of Chicago](#) noted that the idea of fiscal stimulus has been "taught only for its fallacies" in university courses in recent decades.²⁹

In recent years, Keynesian ideas have had a resurgence under the Obama administration. However, the resurgence is likely to be short-lived because of the failure of the administration's \$800 billion stimulus legislation from 2009. Despite that bill and other massive deficit spending in recent years, the economic recovery has been more sluggish than prior recoveries. Stanford University's John Taylor took a detailed look at the economic data and concluded in testimony to Congress in 2011 that the stimulus bill "was not effective in stimulating the economy."³⁰

Other economists found that the 2009 bill may have given the economy a very brief and modest "sugar high," but created a much larger cost over the longer term because of the buildup of government debt. Harvard University's Robert Barro calculated that the future damage caused by the stimulus bill substantially outweighed any short-term benefits because the negative multipliers of raising taxes to pay back debt are much larger than the small positive multipliers from spending.³¹

It is true that economists who are critical of Keynesian stimulus packages are usually more supportive of "automatic stabilizer" spending that kicks in without legislative action when the economy stagnates. However, Congress added large increases to UI benefits during the recent recession, on top of the UI benefits that kick in automatically. Also, note that under a market-based system, payments from privatized UI insurance or UI savings accounts would provide a similar boost to personal income during recessions.

Another thing to consider regarding a government UI system is that any positive stimulus from UI benefits during a recession is reversed later on with the anti-stimulus of higher taxes needed to replenish UI funds. In 2011, for example, with the economy still shaky, two-thirds of the states are planning to increase their UI taxes, which will likely have a negative effect on investment and job creation.³² The bottom line is that government benefit programs do not provide the economy with a free lunch.

Problems Caused by the UI System

Encourages Unemployment

UI is designed to reduce the hardship of being unemployed. To the extent that it does, however, it also reduces the incentive for the unemployed to seek work. If the government subsidizes something, the economy gets more of it, and that is certainly true of joblessness. As noted, benefits replace between 50 and 70 percent of previous wages up to a maximum. Those benefits are substantial enough for many workers to take the opportunity to enjoy more leisure while they receive government support.

There has been a great deal of empirical research on UI. Economists Martin Feldstein and Daniel Altman note, "the most obvious and most thoroughly researched effect of the existing UI systems on unemployment is the increase in the duration of the unemployment spells. By reducing the cost of remaining unemployed, UI benefits induce individuals to have longer spells in order to search for a better job or simply to enjoy some leisure."³³

Studies have found that "extending either the amount or the duration of UI benefits increases the length of time that workers remain unemployed."³⁴ UI benefits delay the need to make tough choices about career options, such as switching industries, taking lower pay, or

moving to a different city. For some workers, the real job search only begins when benefits are nearly exhausted. In fact, research shows that about one-third of workers find a new job as soon as their benefits run out.³⁵

Harvard University's Larry Summers—former Treasury Secretary under President Clinton and former economic advisor to President Obama—summarized the link between government benefits and higher unemployment in a 1999 article:

To fully understand unemployment, we must consider the causes of recorded long-term unemployment. Empirical evidence shows that two causes are welfare payments and unemployment insurance. These government assistance programs contribute to long-term unemployment in two ways. First, government assistance increases the *measure* of unemployment by prompting people who are not working to claim that they are looking for work even when they are not. ... The second way government assistance programs contribute to long-term unemployment is by providing an incentive, and the means, not to work. Each unemployed person has a "reservation wage"—the minimum wage he or she insists on getting before accepting a job. Unemployment insurance and other social assistance programs increase that reservation wage, causing an unemployed person to remain unemployed longer.³⁶

When the *Wall Street Journal* quoted this analysis, Summers responded that during recessions the positive macroeconomic effects of increased spending from UI were more important than these negative microeconomic effects of UI. However, we discussed how such positive Keynesian macroeconomic effects are mainly illusory, and so the economy is left with just the microeconomic damage.

How much unemployment do UI benefits create? Princeton University's Harvey Rosen has reviewed the academic evidence: "A typical finding is that a 10 percentage point increase in the net replacement rate of UI ... increases the duration of unemployment by about 1.5 weeks."³⁷ Thus, if a state increased its UI benefits so that the replacement rose from 45 to 55 percent, workers would tend to claim UI by an additional 1.5 weeks.

In 2010, Harvard University's Robert Barro estimated that the extensions of UI benefits to an unprecedented 99 weeks had increased the U.S. unemployment rate by 2.7 percentage points at the time—from 6.8 percent to 9.5 percent.³⁸ He observed that even though unemployment had peaked at a higher rate in the 1981 recession, the mean duration of unemployment and the share of unemployment that was long-term were much higher in the recent recession. Those are tell-tale signs that a large group of the unemployed were induced to remain on UI because of the generosity of benefit extensions.

Kills Jobs and Cross-Subsidizes Industries

The UI system is financed through employer payroll taxes of more than \$50 billion a year.³⁹ Payroll taxes create a disincentive to hire workers, particularly in those states with above-average UI tax burdens. The average UI payroll tax in 2011 is about \$400 per worker, which is steep enough to give employers pause when they consider adjusting the sizes of their workforces.⁴⁰

The states attempt to have their taxes on each employer correspond to each employer's use of the UI system, which is called "experience rating." Thus, if a business lays off more workers, it will face a higher tax rate. This structure encourages firms to stabilize their employment and discourages them from shifting the UI costs of their layoffs to the broader economy.

However, state UI systems are only partially experience rated. Some employers may go for years without laying off employees and still pay substantial taxes. Other employers may be already at the maximum state tax rate, and so added layoffs don't cost them anything. In this case, layoffs make sense because "the cost to the employer in increased UI taxes is less than the UI benefit to the worker," according to Princeton University's Harvey Rosen.⁴¹

Employers with larger cyclical or seasonal variations in their businesses tend to be the ones doing more layoffs and imposing higher costs on the UI system. A consulting firm that helps design state UI systems notes that about one-third of UI benefits in the United States are "socialized costs," which are the costs that high-layoff firms shift to other firms.⁴² The Government Accountability Office has found that construction and agriculture tend to be subsidized by the UI system, while finance, retail, and real estate tended to pay subsidies.⁴³

Without the UI system, "employers offering seasonal employment would have to pay higher wages in order to compete against employers who offer year-round employment. Unemployment benefits undercut this national market phenomenon and act as a subsidy to employers whose need for labor is cyclical or seasonal."⁴⁴

Note that without the UI system, cyclical industries would probably adopt more flexible wage systems in order to stabilize employment. If a cyclical business used a system of base pay plus bonuses tied to the company's performance, the company would be able to minimize layoffs during downturns by simply cutting back on the bonuses.

In sum, the UI system distorts pay structures and company employment decisions, while generating differential subsidies and burdens on industries. The system could be improved with fuller experience rating, but the reality is that all taxes—however applied—damage private economic activity. One economist noted, "one of the worst aspects of the UI tax system is that financially troubled businesses, where layoffs may be a matter of survival, actually pay higher marginal rates as they are forced into higher tax rate schedules ... this has long been called the shut-down effect of UI taxes: failing businesses face climbing UI taxes, with the result that they fail sooner."⁴⁵

Subsidizes and Penalizes Workers

The UI system favors some workers over other workers. It favors eligible workers over those who are ineligible for a variety of reasons, such as part-time workers who have insufficient earnings to qualify. Yet employers of part-time workers still have to pay the UI tax on their earnings, which ultimately reduces the earnings of part-timers. Thus low-earning part-time workers partly bear the burden of a system that does not benefit them.

Another group of workers who are ineligible are those who are fired, or discharged for cause. The idea is to prevent people from provoking their own firing if they want to collect benefits rather than work. But most firings are over factors such as poor job performance; they are not deliberately provoked. These fired workers have "contributed" to the UI system through the employer's payroll taxes, yet they cannot collect.

Finally, we noted that firms with stable employment tend to subsidize firms with less stable employment. Over the long run, that effectively means that the UI system transfers income from workers in more stable industries, such as retail, to workers in less stable industries, such as construction.

In sum, the UI system's safety net is one that imposes costs on all workers, but benefits only some. Unfortunately, that is a general problem with government benefit programs—they create winners and losers in society. Personal UI savings accounts would eliminate this problem of unfair cross-subsidies.

Suppresses Personal Saving

Individuals save for a number of different reasons, one of which is as a precaution against contingencies such as unemployment. Looking at the results of simulation studies, economists Eric Engen and Jonathan Gruber note that "precautionary saving is a significant, and perhaps the most important, determinant of individual wealth accumulation."⁴⁶

Unfortunately, the provision of government UI benefits directly undercuts this key reason for personal saving. Engen and Gruber's analysis shows that "raising the UI benefit replacement rate by 10 percentage points lowers median wealth-income ratios by about 7 percent."⁴⁷ The more generous are benefits, the less incentive people have to save.

This anti-savings effect of the UI system creates a problem for the broader economy because personal saving helps to fuel growth. In a market economy, savings are channeled into capital investment, which raises the economy's productivity and ultimately boosts worker wages.

We mentioned the pro-savings culture that developed during the 19th century before the modern welfare state. That culture helped fuel America's rapid economic growth at the time. One scholarly paper noted that "growth of the U.S. economy in the nineteenth century was stimulated by a substantial increase in the aggregate saving rate. This higher saving rate resulted from decisions made at the microeconomic level by individuals who saved for their own purposes—to tide themselves over rough times, to accumulate for major purchases, to prepare for old age, and to make bequests."⁴⁸

The UI system is supposed to be savings-based, with governments building up their state trust funds in good years to pay higher benefits in recession years. However, many states have moved away from forward funding their UI systems, favoring to borrow more from the federal government when their benefit claims deplete their funds. During the recent recession, many states have had to take large loans from the federal government to keep their systems afloat.

The UI program is only one of many welfare-state programs that suppress personal savings. Unfortunately, younger generations of Americans have grown up with all these programs, and they have been conditioned to spend nearly all their income, while putting little aside for rainy days or retirement. Why save if the government has you covered? The UI program is responsible for only part of the pro-consumption bias in today's economy, but its anti-saving effect is one more strike against the current system.

Waste, Fraud, and Administrative Costs

When policymakers dream of ways to provide subsidies and safety nets to groups in society, they rarely take into account the large bureaucratic costs that are inevitably involved. The UI system is a complex and costly system for governments and businesses to administer.

State governments must raise taxes from almost 8 million businesses, with tax bills specifically calculated for each firm's experience rating. At the same time, the states dole out individually calculated benefits to millions of workers and monitor whether each person making a claim is currently eligible. Businesses and states need to adjudicate the many disputed claims for benefits, and states need to police UI tax evasion as businesses try to manipulate the system to get a lower tax rate.

Federal and state UI administration cost taxpayers \$5.9 billion in 2010.⁴⁹ Despite this large cost, there is widespread concern among experts that the UI system is "in long-term decline" from an administrative perspective.⁵⁰ UI computer systems are apparently far outdated in many states, and administrators say that they need more money to do their jobs competently.

One problem is that state UI tax systems are very complex.⁵¹ There are four different experience-rating systems, and there are three different methods of determining which businesses to charge when a worker makes a claim. States have various exclusions to the UI tax base, and new businesses have special rules because they don't have an experience rating yet. Most states also impose a range of added charges to basic UI taxes, such as solvency taxes, taxes for socialized costs, reserve fund taxes, and various surtaxes.

Employers face substantial costs to deal with all the paperwork and tax planning needed to comply with the UI system. For example, the National Federation of Independent Business notes that regardless of eligibility, "many departing employees automatically file for unemployment compensation. They have nothing to lose; filing a claim costs nothing and it puts the ball in the employer's court."⁵² Businesses are then forced to spend time and money fighting unjustified claims.

There is a substantial amount of waste, fraud, and abuse in the UI system. Many people try to grab benefits improperly, including people who are ineligible, people who are not actively looking for work, and people who have taken jobs and neglect to report it. Other problems include the misreporting of earnings, the provision of false ID to gain benefits, and falsifying reasons for employment termination.

The Department of Labor estimates that the improper payment rate for UI is about 11 percent, which amounted to \$17 billion of wasted taxpayer money in 2010.⁵³ If you Google the phrase "unemployment benefits fraud," you find a huge number of news stories.

The bottom line is that government benefit programs such as UI are subject to large administrative costs and widespread abuses, which represent losses to taxpayers and the economy. The larger subsidy and benefit programs become, the larger the army of people doing paperwork and transferring wealth in society, rather than adding to wealth by producing real products.

Conclusions

The federal government has locked the states, businesses, and individuals into an economically damaging unemployment insurance system. Congress should reconsider the 1930s-era approach to UI because there are likely to be lower-cost, market-oriented solutions available in today's advanced economy.

One reform approach is to substitute personal UI savings accounts for the current tax-and-benefit system. The nation of Chile enacted such a system in 2002, building on the success of its Social Security personal account system.⁵⁴ A detailed study of the Chilean reform in 2010 found that the personal UI accounts had improved work incentives and reduced unemployment.⁵⁵ Such accounts can also add to the long-term retirement savings of workers.

An alternative reform would be to fully devolve UI responsibility to the states. The states already have substantial discretion under the current system, so federal involvement simply adds an extra layer of rules and bureaucracy. The states would then be free to move to a more market-oriented system, and they could repeal any laws that obstruct insurance firms from offering private UI policies.

In addition to these reforms, the federal government should make tax code changes to boost personal savings. While the tax code has a variety of vehicles for retirement saving, families must generally use taxable savings to put money aside for rainy days, such as periods of unemployment. One reform approach would be to liberalize Roth IRAs to allow tax-free withdrawals for any reason, including unemployment. Such accounts could be modeled after Canada's Tax-Free Savings Accounts, which were instituted in 2009.⁵⁶ The advantage of allowing tax-free withdrawals at any time and for any reason is that it increases liquidity and thus encourages greater personal savings.

Without the current UI taxes, businesses would have increased incentives for hiring and for exploring alternatives to layoffs during downturns. Individuals would have strong incentives to increase their personal savings, and during spells of unemployment they would be more diligent in searching for work and taking available opportunities.

The elimination of the current federal safety net for unemployment would create challenges to some people, but the payoff would be better workforce incentives, an increase in personal thrift and financial responsibility, and a more growth-oriented economy that would create better job opportunities all around.

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¹ *Budget of the United States Government, Fiscal Year 2012, Historical Tables* (Washington: Government Printing Office, 2011), Table 3.2.

² For a discussion of early foreign systems, see Social Security Board, *Unemployment Compensation: What and Why?* (Washington: Government Printing Office, March 1937).

³ F. Morley, "Unemployment Insurance in the United States," *CQ Researcher (Editorial Research Reports)*, January 23, 1926.

⁴ F. Morley, "Unemployment Insurance in the United States," *CQ Researcher (Editorial Research Reports)*, January 23, 1926.

⁵ F. Morley, "Unemployment Insurance in the United States," *CQ Researcher (Editorial Research Reports)*, January 23, 1926.

⁶ Quoted in F. Morley, "Unemployment Insurance in the United States," *CQ Researcher (Editorial Research Reports)*, January 23, 1926.

⁷ Today, Sweden, Denmark, and some other countries use the "Ghent system," under which the labor unions are responsible for handing out unemployment insurance benefits. Union membership tends to be high in those countries.

⁸ Social Security Board, *Unemployment Compensation: What and Why?* (Washington: Government Printing Office, March 1937).

⁹ Social Security Board, *Unemployment Compensation: What and Why?* (Washington: Government Printing Office, March 1937).

¹⁰ *Budget of the United States Government, Fiscal Year 2012, Historical Tables* (Washington: Government Printing Office, 2011), Table 2.4.

¹¹ Bureau of Labor Statistics, "Unemployment Insurance Data Summary," 4th Quarter 2010, www.workforcesecurity.doleta.gov/unemploy/content/data.asp.

¹² Kail Padgitt, "2011 State Business Tax Climate Index," Tax Foundation, October 2010, p. 31.

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¹⁴ House Committee on Ways and Means, *Green Book* (Washington: Government Printing Office, March 2004), p. 4–16.

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- ³⁶ Quoted in *Wall Street Journal*, "Summers on Demand," April 16, 2010. And see *Wall Street Journal*, "Incentives Not to Work," April 13, 2010.
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