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Employment Research

JULY 2000

U.S. Unemployment Insurance
Progress and Prospects

Rising Wage Inequality
in Urban Labor Markets

New Books

Vol. 7, No.2

Employment Research is now published quarterly by the W.E. Upjohn Institute for Employment Research. Issues will appear in January, April, July, and October.

The Institute is a nonprofit research organization devoted to finding and promoting solutions to employment-related problems at the national, state, and local level. The Institute is an activity of the W.E. Upjohn Unemployment Trust Corporation, which was established in 1932 to administer a fund set aside by the late Dr. W.E. Upjohn, founder of the Upjohn Company, to conduct research on the causes and effects of unemployment and seek measures for the alleviation of the hardships suffered by the unemployed.

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U.S. Unemployment Insurance: Progress and Prospects

[Editors Note: This article is the fifth in a series on "Research Questions for the New Millennium." The series aims to identify research needed to inform employment policy in the near future.]

The federal-state system of unemployment insurance (UI) in the United States was established by provisions in the Social Security Act of 1935. Public acceptance of and political initiative for the system emerged from the widespread hardship resulting from high unemployment in the Great Depression. The original UI provisions aimed to partially replace lost income for involuntarily unemployed workers, to reduce the dispersal of skilled workers when employers make temporary layoffs, to help maintain aggregate purchasing power during economic downturns, and to prevent the breakdown of general labor standards during such periods.

As we enter the 21st century, the longest economic expansion since World War II is continuing, and labor shortages are developing in many areas. In addition to meeting existing obligations, the UI system faces an added list of challenges. This article offers a brief overview of the

UI system as it operates today and suggests topics for research which could inform the further development of UI.

Eligibility and Benefits

Unemployment insurance is social insurance. It combines insurance principles with considerations of social adequacy. UI is intended to partially replace lost earnings for involuntarily unemployed persons with sufficient prior employment, who are able, available, and actively seeking work.

As insurance, UI requires that premiums be paid in advance through employer taxes on wages earned in the prior year. Initial eligibility requires that earnings in UI-covered employment exceed a state-specified minimum. States usually require at least \$1,000 in earnings, with a higher level required for higher benefits.

Balancing social adequacy and work incentives, state laws provide that UI will replace about one-half of prior wages, subject to a maximum and minimum, for up to 26 weeks. In 1999, the weekly benefit amount averaged \$200. During the past half century, UI has replaced on average one-third of lost wages (Table 1, column 1).

Research suggests that UI payments slightly prolong unemployment spells. Evaluation of strategies to improve reemployment incentives has informed the adoption of policies that target job search workshops and self-employment assistance. Beginning in 1994, the Worker Profiling and Reemployment Services (WPRS) system required special job search training for those identified as being most likely to exhaust UI benefits. Lessons from WPRS can inform the targeting of services at newly established one-stop career centers in workforce investment areas.

The original focus of the UI system on prime-age, full-time workers in a labor surplus economy remains largely unchanged to this day. However, in the current labor shortage situation, broadened UI eligibility for part-time, contingent, and self-employed workers could increase labor force participation and help ease tight labor markets. Research should investigate the financing costs and effects of permitting continued UI eligibility for those only seeking return to part-time work, as well as reimbursable benefit arrangements for self-employed and contingent workers.

The U.S. Department of Labor recently drafted regulations to allow states to use UI reserves for paying benefits to households in which parents have chosen to take parental or family leave. This essentially expands UI eligibility to include beneficiaries who are not actively seeking work. The impact of such expansions on the ability of the UI system to finance its core objectives should be carefully evaluated.

Coverage and Reciprocity

UI coverage has steadily expanded over the years to encompass virtually all full-time permanent wage and salary workers (Figure 1). Initially, only employers with eight or more workers were covered; that was relaxed to four employees in 1954, and to one employee in 1970. In the early 1970s, nonprofit firms and state and local governments became covered. As coverage steadily expanded, the rate of UI reciprocity gradually fell. Beneficiaries now

Figure 1 UI Coverage and Reciprocity Rates in the U.S., 1948–1998

SOURCE: U.S. Department of Labor, 2000. *Unemployment Insurance Financial Data: ET Handbook No. 394*. Washington, D.C.: Employment and Training Administration (http://www.itsc.state.md.us/ui_manage/HDBK394_99/inkus.html) and U.S. Department of Labor, 2000. *Employment and Earnings*. Washington, D.C.: Bureau of Labor Statistics (<http://www.bls.gov/cpsatabs.htm>).

constitute only about 35 percent of all unemployed (Figure 1).

Even among those eligible for benefits, only about two-thirds bother to collect. In addition to raising questions about social adequacy, low reciprocity may weaken the counter cyclical potential of the federal-state UI system. Increased UI reciprocity has become a major objective of the U.S. Department of Labor. UI has acted as an automatic stabilizer for the economy. In times of economic recession, aggregate UI payments have risen to more than three-quarters of 1 percent of gross domestic product (GDP), while automatically falling below one-quarter of 1 percent of GDP in years of low unemployment (Table 1, column 2).

Over the years, the countercyclical effect of UI has frequently been supplemented by temporary federal programs that extended benefits beyond 26 weeks. Following high unemployment in the early 1980s, the federal government instituted a permanent, federally funded, extended-benefits program. Nonetheless, during the 1991 recession, another temporary federal extended-benefits

program was enacted. Research about how to ideally structure and finance an extended benefits program should continue.

Financing Benefits

UI was established through a federal tax levied on employer payrolls, with 90 percent of the revenue returned to states that establish and operate UI programs consistent with requirements in the federal law. There is wide variation among states in UI provisions, but all comply with federal statute as monitored by the U.S. Department of Labor.

A key federal requirement is that taxes be experience-rated, meaning that tax rates move in tandem with a firm's layoffs and UI benefit charges. Research finds that when experience rating operates without restriction, it acts to stabilize employment. However, tax rate maximums, minimums, and time lags in tax adjustment weaken the response.

The benefit financing system is designed to minimize the tendency of UI taxes to reinforce economic contraction. Reserves are replenished gradually by tax contributions after they are drawn down

Table 1 Benefit and Financing Trends in the U.S. Federal-State UI System, for Selected Years 1938–1998

Year	(1) Wage replacement rate ^a (%)	(2) UI benefit payments as a % of GDP	(3) Reserve ratio ^b (%)	(4) Average UI tax on covered payrolls (%)
1938	43.1	0.46	4.22	2.69
1943	33.6	0.03	7.13	1.86
1948	34.1	0.30	7.91	1.01
1953	32.3	0.26	6.41	0.93
1958	35.3	0.77	3.99	0.84
1963	34.6	0.46	2.88	1.34
1968	34.3	0.23	3.54	0.76
1973	36.1	0.30	2.13	0.99
1978	36.4	0.35	0.55	1.41
1983	37.2	0.52	0.00	1.20
1988	34.9	0.30	1.71	0.96
1993	36.0	0.34	1.25	0.90
1998	32.9	0.23	1.51	0.62

^aWage replacement rate is the average UI weekly benefit amount divided by average weekly wage in UI covered employment.

^bReserve ratio is accumulated holdings in UI benefit trust funds divided by total payrolls in UI covered employment $\times 100$.

SOURCE: U.S. Department of Commerce. *Survey of Current Business*. Washington, D.C. and U.S. Department of Labor. *Unemployment Insurance Financial Data: ET Handbook No. 394*. Washington, D.C.: Employment and Training Administration.

by benefit payments. The most severe financial strain ever experienced by the system occurred in 1975, when benefits totaled 2.2 percent of covered payrolls. From 1975 to 1987, total system reserves never exceeded 1 percent of covered payrolls. By 1982, UI benefit trust funds were completely exhausted (Table 1, column 3). The response among states was tightened eligibility, which conserved funds but contributed to diminished reciprocity rates.

Recent years have witnessed a slow and modest recovery in system-wide reserves. As a proportion of total covered wages, UI taxes have hovered around 1 percent, being well below this level in recent years after a long economic expansion (Table 1, column 4). There are no strong incentives for states to provide significant forward financing of benefits, and the U.S. Department of Labor is moving toward a first-time relaxation of reserve adequacy guidelines. Indeed, a few states have moved to zero tax rates for employers, having a positive balance.

Research into the effects of broadening the federal taxable wage base on each worker's earnings from \$7,000 per year could help inform benefit finance policy.

Administration

Unemployment tax collections retained by the federal government are used to finance program administration through grants to the states and to make loans to the states when liquidity problems arise. Grants for administration are done by a formula based on workload factors such as the number of UI claims, appeals, and covered employers.

UI tax receipts are held in the Unemployment Trust Fund (UTF), which is part of the unified federal budget. Federal budget deficits through the late 1990s induced the federal government to conserve funds, while the states claimed that federal holdings for administration were state entitlements that should be distributed.

Research has suggested that to encourage high-quality service, efficient

low-cost administration, and continuous quality improvement, the administrative funding mechanism should 1) be based on the quality of service as measured through a simple monitoring system operated by the federal partner to assess state practice, and 2) permit states to retain unspent financial grants. Such a system should encourage UI taxpayers to monitor administrative efficiency, so as to increase the share of administrative grants retained for other uses including benefit payments.

States have increasingly viewed the administration of UI as simply a disbursement function. Federal quality control random audits identified failure to satisfy the "actively seeking work" requirement (or "work test") as the prime source of payment errors. States have improved the timeliness and accuracy of payments, but to do so they have often weakened the work test that linked UI to reemployment efforts of the public employment service.

Mechanisms to encourage return to work may be further weakened by telephone systems for initial and continued UI claims. The use of such systems is expanding rapidly, and Internet-based systems are appearing. Telephone claim systems could affect both entry to the UI system and the duration of benefit receipt. These are important policy questions which are now just beginning to receive research attention.

Conclusion

Given the present and likely future labor shortages facing U.S. employers, additional changes in UI that promote reemployment and labor force participation should be studied. Added labor supply might be forthcoming if eligibility conditions were changed to permit UI access for part-time, part-year, and self-employed workers. Research suggests that labor force participation for all of these groups is more responsive to UI entitlement than that for prime-age wage and salary workers.

A severe recession has not tested UI financing and claims processing capacity in nearly 20 years. In preparing for the inevitable next recession, the issue is not

only the adequacy of UI reserves, but the sufficiency of telephone claims and other UI administrative mechanisms in the new one-stop environment for public employment services.

Since it was first established, the federal-state UI system has provided income replacement for millions of jobless workers and security for countless others who succeeded in the labor market knowing they had earnings insurance to fall back on. UI has become such an integral part of workplace decisions that it is taken for granted. The narrow aim of providing income security for workers is a crucial one. Achieving this at minimal cost of foregone private investment is a huge challenge. As a wealthy society, we may collectively choose to pursue other goals. We should also recognize that the narrowly focused and self-financed UI system has served its function well.

Suggested Reading

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Christopher J. O'Leary is a senior economist at the Upjohn Institute.

Grants Awarded

The Institute is pleased to announce the winners of its 2000 Grant Program. They are

- Saul D. Hoffman and Laurence S. Seidman, University of Delaware, for "The Earned Income Tax Credit: An Exposition and Evaluation." This study will analyze, evaluate, and critique the EITC as it exists in the year 2000. The topics will include the design of EITC and the program's impacts, the EITC and the minimum wage, state EITCs, and potential revisions of EITC. Critical surveys of the relevant literature will also be included.
- Robert L. Kaufman, The Ohio State University, for "Integrating Race-Sex Queuing and Labor Market Segmentation Approaches: Segregation and Earnings among Black Females, Black Males, White Females, and White Males." This project will explore how the determinants of segregation and earnings gaps are moderated by (interact with) economic

factors such as market power, by societal factors such as regional differences between the north and the south, and by changes occurring between 1980 and 1990.

- Ethan B. Kapstein, University of Minnesota, and Branko Milanovic, World Bank, for "Responding to Globalization: Social Policy in Emerging Market Economies." This study will analyze developments and trends in the provision of social insurance and social assistance (welfare) in emerging markets (including post-Communist economies), and it will seek to determine how globalization affects state welfare policies, whether there is convergence or divergence in social programs around the world, and what the appropriate role is of the international community in shaping social policy development and reform.

Details on the Institute's 2001 Grant Program will be announced in the fall.

Seeking Manuscripts

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The majority of the books we publish originate from our Grant Program or from the Institute's in-house staff of professional economists. However, we also invite submissions of publishable book-length manuscripts and proposals for books from outside scholars and policy analysts. These submissions will be reviewed promptly by Institute staff, and manuscripts that appear promising will receive external anonymous peer review.

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Thomas Hyclak

Rising Wage Inequality in Urban Labor Markets

[Editor's Note: This article is based on a forthcoming book by Professor Hyclak. See p. 7.]

Much attention has been paid to the widening wage gap between skilled and unskilled workers during the 1980s; that gap is evidenced by the 35 percent increase in the earnings ratio of college educated workers relative to high school graduates. However, wage inequality among workers with the same skill or education level also increased markedly during the 1980s. The attempt to identify the causes of this complex rise in wage inequality has been the focus of much research.

The Area Wage Surveys (AWS) data allow us to calculate measures of inequality for the distribution of hourly wages paid to workers in about 40 different jobs clustered in four occupational groups: professional-technical, clerical, skilled maintenance and material movement, and security and janitorial. In Table 1, the first two columns report data on a standard measure of wage dispersion, the variance of the natural logarithm of real hourly wages, for all workers in the surveyed jobs for the first and last available observation in each of 20 metropolitan areas.

This inequality measure shows that wage dispersion increased substantially in all 20 areas from the mid 1970s to the late 1980s and early 1990s, although there is considerable variation in the magnitude of the increase. The real wage variance increased by 50 percent or more in 13 localities, and it doubled in Cleveland and Houston. The smallest increase was in Anaheim, where there was a 22 percent increase from 1975 to 1988. The increased wage variance in each of these labor markets reflects both an increase in

the variance of average wages across the four occupational groups and an increase in the variance within each occupation. The relative importance of these two sources also varied considerably across the 20 labor markets.

In the third column of Table 1 are forecasts of the overall wage variance for the last year for each area. These forecasts are derived from statistical regression models that attempt to use different characteristics of these labor markets to predict the average real wage and the real wage variance over time.

The forecast wage variances are quite good. The models forecast an increase in variance in all areas, and the forecast increases are of the same order of magnitude of the actual changes. This is shown by the fact that the means and standard deviations of the actual and forecast variances are practically the same. The correlation coefficient between the forecast and actual variances is 0.69, and the mean absolute error in the forecast (0.02) is small relative to the mean value for the wage variance among the 20 areas. This forecast performance gives us confidence that the regression models used to analyze the wage structure across and within occupations were indeed able to capture some of the important determinants of rising urban wage inequality during the 1980s.

What then do these regression models tell us about the causes of rising wage

Table 1 Changes in Wage Inequality During the 1980s in 20 Urban Areas

Area and sample period	Wage variance		
	First year	Final year	Forecast, final year
Anaheim, 1975-88	0.1289	0.1571	0.1458
Atlanta, 1975-91	0.1249	0.2003	0.1927
Baltimore, 1975-91	0.1584	0.2024	0.2418
Chicago, 1974-86	0.0975	0.1550	0.1598
Cincinnati, 1974-89	0.1205	0.1889	0.1875
Cleveland, 1974-90	0.1163	0.2379	0.1880
Detroit, 1976-89	0.1152	0.1993	0.1783
Houston, 1974-90	0.1562	0.3113	0.2361
Indianapolis, 1975-88	0.1535	0.2165	0.2040
Los Angeles, 1975-89	0.1238	0.1808	0.1981
Miami, 1975-90	0.1233	0.1821	0.2138
Milwaukee, 1975-91	0.1229	0.1907	0.2328
Minneapolis, 1975-91	0.1167	0.1607	0.1538
Nassau-Suffolk, 1975-87	0.1076	0.1411	0.1582
New York, 1975-88	0.0895	0.1649	0.1863
Philadelphia, 1976-88	0.1143	0.1787	0.1871
San Diego, 1974-89	0.1104	0.2001	0.2263
San Jose, 1975-88	0.0899	0.1520	0.1427
Seattle, 1974-88	0.0943	0.1718	0.1758
St. Louis, 1976-89	0.1356	0.2370	0.2253
Mean	0.1199	0.1914	0.1918
Standard deviation	0.0200	0.0387	0.0306

SOURCE: Author's calculations from Area Wage Survey data. Wage variance is the variance of the natural logarithm of real hourly wages. The local CPI is used to adjust for inflation. Forecasts are derived from regression models of the determinants of the logarithm of real hourly wages and the wage variance for occupations in each area over time.

inequality? Four important factors can be identified from the regression results.

1) The differential impact of the recession of the early 1980s on occupational unemployment rates is an important determinant of inequality that may not have been given sufficient attention in previous inequality studies. That recession led to sharp increases in unemployment rates for blue-collar workers. For example, in Detroit the unemployment rate in 1982 was almost 27 percent for unskilled laborers and 16.5 percent for skilled maintenance workers. Unemployment rates for white-collar workers rose less dramatically in the recession and recovered more quickly. As a result, the unemployment rate differences among the four occupations widened considerably in the early 1980s and recovered much more slowly in the late 1980s. This contributed to a widening of wage differentials across occupations and an increase in wage variances within occupations.

2) Declining union contract coverage also contributed to rising wage inequality. The AWS reported the percentage of full-time plant and office workers in surveyed establishments where a majority of workers were covered by union contracts. On average, this percentage fell by 18 percentage points for plant workers and 2 percentage points for office workers during the sample period. This general decrease in union coverage was associated with rising inequality within occupations, and the differential rate of decline for office and plant workers added to wage inequality across occupations.

3) Decreases in the minimum wage, adjusted for changes in the local cost of living, were another important institutional determinant of rising wage inequality. For example, the real minimum wage in Atlanta fell from \$4.16 in 1978 to \$2.95 in 1987, before rising again to \$3.18 in 1991. The regression results show that the level of the real minimum wage had the greatest effect on the average real wage of unskilled workers, so this type of decline added to wage inequality across occupations. Also, as the real minimum wage fell, the gap between the median wage and minimum wage within occupations

widened, contributing to increased wage inequality within occupations.

4) The regression models indicate considerable lags in how wages in local occupational labor markets respond to changes in labor market conditions and policies. Shocks to the occupational wage level or wage variance do dissipate over time—other things unchanged—as supply and demand adjust in the local market. However, there is also evidence that this adjustment would occur slowly over time. This is an important factor to consider when examining the impact of the early 1980s recession on wage inequality. The severity of that recession, especially in local blue-collar labor markets, had large effects on wage disparity across and within local occupations that persisted over much of that decade, even in the face of economic recovery and the self-adjusting dynamics revealed by the models.

The regression models also controlled for changes in the skill mix of jobs within each local occupational group and in the industry mix of employment in the metropolitan area. It is not easy, however, to summarize the effects of these variables on wage dispersion. For example, a shift in employment within an area away from high-compensation industries would lower average occupational wages but would also reduce dispersion within each occupation. A shift toward a higher skill mix of jobs within an occupation would raise the occupational average wage level but would lower dispersion within that occupation. The differential effect of these variables across and within occupations helps explain why previous studies have found so often that changes in industry and occupational structure have relatively minor impacts on wage inequality.

This study of the causes of rising wage inequality during the 1980s among workers in urban labor markets suggests a couple of conclusions and, like many empirical studies in economics, raises a number of questions for further research. The key conclusion is that the rise in inequality can be traced to the interaction of high unemployment and changes in the institutional environment that reduced the influences of unions and government

regulation on the wage structure. From this perspective, the 1980s can be usefully compared to previous periods of falling wage disparity, such as the 1940s, when very tight labor markets and rising union influence contributed to sharp decreases in wage disparity (see Goldin and Margo 1992). Further, the experience of the 1990s—with very low unemployment rates, increases in the minimum wage and signs of falling wage inequality (see the Economic Report of the President 1999)—appears to confirm our analysis of the 1980s experience in urban labor markets. This suggests that the most effective policy approach to achieving greater wage equality is the maintenance of a low-unemployment environment.

This research does not, unfortunately, help clarify the roles of technological change or of changes in the relative importance of foreign trade in driving the ultimate changes in wage inequality. There is evidence that structural changes in labor demand played an important role in determining urban unemployment rates in the first half of the 1980s (Hyclak 1996). These structural changes may well have been induced by some combination of trade competition and technological change. Similarly, the rapid decline in union influence during the 1980s may be traceable, in part, to such factors. Perhaps the analysis of the evolution of the wage structure over the very different decades of the 1980s and 1990s will be able to sort out the relative influence of the macroeconomic environment and structural change on wage inequality.

Thomas Hyclak is Chair of the Economics Department at Lehigh University.

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New Books from the Upjohn Institute

The Economics of Sports

William S. Kern, editor

Professional and major college sports has outgrown its image as a pastime. Fueled by rising disposable incomes, the public's demand for sporting events has helped generate a multibillion-dollar economy that produces winners and losers both on and off the field

The papers in this collection are authored by economists at the forefront of the movement studying the economics of sports. By using examples such as

the 1998–1999 NBA lockout, the economic effects of sports stadiums—such as the now-defunct Seattle Kingdome—on their neighborhoods, and the parity of competition in leagues and conferences, the authors together are able to present a detailed account of contemporary economic issues on display in the field of sports. These issues include industrial organization, influences on labor markets (such as discrimination), monopsony power, the behavior of cartels, and the practice of price discrimination.

Given the interest many students have in sports, this accessible volume would be a useful medium for teaching economics in the classroom.

Contributors include **Rodney Fort, Robert A. Baade, John J. Siegfried, and Timothy Peterson, Richard G. Sheehan, Andrew Zimbalist, and Lawrence M. Kahn.**

140 pp. \$33 cloth ISBN 0-88099-210-7
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Full text of the first chapters of these books is available at <http://www.upjohninst.org>.

Employee Benefits and Labor Markets in Canada and the United States

William T. Alpert and
Stephen A. Woodbury, editors

This collection includes 14 chapters that highlight the principal features and related policy issues of employee benefits, including retirement income, health care,

unemployment insurance, workers' compensation, and life insurance.

Following the editors' introduction and an overview chapter the book is divided into four parts. Part I deals with labor supply, specifically the relationship between employee benefits and work. Part II examines the relationship between employee benefits and the demand for labor. Part III includes chapters that consider the implications of employee benefits for worker turnover, wages, and equity. Part IV focuses on pensions and public policy toward retirement income.

Contributors include **Sherwin Rosen, Charles Michalopoulos, Philip K. Robbins, Paul Fronstin, Eileen Trzcinski, William T. Alpert, Jonathan Gruber, Masanori Hashimoto, Dan A. Black, Craig A. Olson, Janet Hunt-McCool, Thomas J. McCool, Avi Dor, Daniel J. Slottje, Stephen A. Woodbury, Rod W. Anderson, Morley Gunderson, Douglas Hyatt, James E. Pesando, Stuart Dorsey, John A. Turner, and Patricia B. Reagan.**

550 pp. \$46 cloth ISBN 0-88099-206-9
\$29 paper ISBN 0-88099-205-0 / 2000.

Rising Wage Inequality

The 1980s Experience in
Urban Labor Markets

Thomas Hyclak

Where most studies of wage inequality use samples drawn from a nationwide pool, Hyclak explores

growing wage inequality by studying four groups of workers employed in 20 local labor markets from the period 1974–1991. Specifically, Hyclak sets out to

answer the following questions:

1. Are trends in the structure of wages in local labor markets similar to the trends in the structure of wages revealed in nationwide studies?

2. Do local labor markets differ in the extent and pattern of the rise in wage inequality?

3. Have changes in the availability of benefits accompanied changes in the wage structure?

4. How have the wage returns on skills changed?

5. What is the relative importance of changes in union contract coverage and in the minimum wage in explaining changes in the wage structure?

Chapters 2 and 3 present a descriptive analysis of changes over time in the structure of wages in the 20 metropolitan labor markets. Chapters 4 and 5 examine determinants of the level and distribution of wages. Hyclak's empirical work in these chapters leads

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