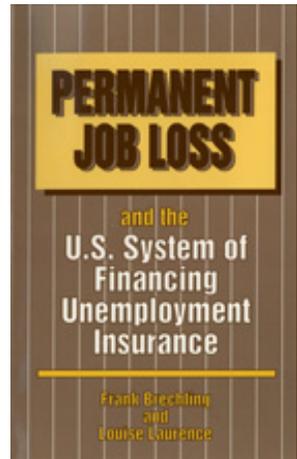


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Introduction and Summary

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**Permanent Job Loss and the U.S. System of Financing
Unemployment Insurance**

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Introduction and Summary

The U.S. unemployment insurance (UI) system is unique in the world in that it is financed by an *experience-rated* payroll tax. This means that individual firms pay higher or lower UI taxes depending on whether they cause more or less unemployment—and unemployment benefit payments. Experience rating internalizes the costs of unemployment to individual firms, thereby inducing them to stabilize employment patterns. Hence, experience rating may lead to a reduction in layoffs and in unemployment.

Since the inception of the federal-state UI system in the mid-1930s, the experience-rating provisions have been vigorously debated among politicians, trade unionists, business people, and academic economists. The last comprehensive treatment of all aspects of experience rating was undertaken by Joseph M. Becker, whose seminal book on this topic was published in 1972. His views were restated, with minor modifications, in his 1981 monograph. Becker's work was followed by the contributions of Feldstein (1976), Brechling (1977), and Baily (1978). The early literature was surveyed by Hamermesh (1977, 1978), Gustman (1982), and Topel and Welch (1980).

The Need for Research

In the research underlying this book, we have reexamined the role of experience rating in the UI system. Such a reconsideration is needed because of recent changes in labor market conditions, including the growth in *permanent* employment reductions due to major downsizing by some large employers, increased numbers of plant closures, and bankruptcies. Large structural shifts in economic activity and employment took place in the 1980s, and they are likely to continue. Thus, the question arises as to whether the present UI system and, in particular, its experience-rating provisions are capable of coping adequately with the consequences of the substantial reallocation of labor. Our research

is aimed at providing some answers to this important economic and political question.

Current systems of experience rating seem to be well designed to allocate the costs of unemployment caused by temporary, easily predictable, and recurrent layoffs. Such layoffs do not lead to significant permanent employment changes. There are valid arguments for allocating the costs of temporary layoffs to the firms that caused them. Further, in most states, it seems that the existing experience-rating systems can be modified to allocate these costs to the appropriate firms.

Most theoretical and empirical investigations of the UI system have been based on models of temporary layoffs. For instance, the influential article by Feldstein (1976) and later contributions by Wolcowitz (1984) and Cook (1992), all employ an approach, similar to that of early implicit contract theories, in which employees have a lasting attachment to a particular firm, but are laid off periodically and later recalled in a fairly predictable manner. In these models, UI benefits are a means of raising workers' incomes during periods of temporary unemployment, and, so the argument goes, these benefits ought to be regarded as part of the firm's labor costs. If, by contrast, UI benefits were financed by a general payroll (or other) tax not based on an experience rating, there might be more layoffs, and high-layoff firms would receive a permanent subsidy from low-layoff firms. As a result, high-layoff activities would be expanded. Experience rating clearly leads to increased efficiency and social well-being, at least from a long-run perspective.

In much of the UI research, experience rating is modeled in a fairly abstract manner. For example, following Feldstein's original contribution, many researchers have described experience rating simply by the ratio of total benefits charged to the tax payments of employers. The reserve ratio method of experience rating, which is the most commonly used approach, has been modeled by Brechling (1977) and, more recently, by Wolcowitz (1984) and Cook (1992). Cook has extended the work to the benefit ratio method, the other important technique of experience rating. Both approaches imply that experience rating is imperfect in the sense that (1) there are substantial lags between the payments of benefits to workers and the corresponding receipt of UI taxes, and (2) there are maximum and minimum tax rates that curtail or even suspend the relationship between benefits and taxes. Although

these features of the UI tax systems have been modeled in an insightful manner by both Wolcowitz and Cook, neither examines the effects of *permanent* employment reductions.

Suppose now that a substantial proportion of total layoffs is permanent, necessitated by some structural development, such as changes in tastes, new technologies, or competition from imports. Some plants may have to close completely, some may go into bankruptcy, and others may experience substantial downsizing. In any case, employment in the industry must contract substantially. From a social point of view, who should bear the unemployment costs of these layoffs? Is experience rating a desirable property of the UI system? Do present experience-rating methods allocate these costs appropriately? These types of questions have not been considered in the previous literature on experience rating. Consequently, we have addressed these issues in our research for this book.

Study Results

Our work has produced a number of findings. First, permanent employment reductions amount to about 70 percent of total employment reductions. While employment reductions are not necessarily the same as layoffs, our evidence, using UI data for Texas for 1978-89, together with some previous results, indicates that permanent layoffs are a significant proportion of total layoffs. Thus, our analysis of experience rating in the context of permanent layoffs seems justified.

Second, based on our theoretical model, the socially optimal rate of moving labor from contracting to expanding sectors can be achieved only when the transfer costs are borne either by the laid-off employee or by the employer in the contracting industry. *The agent who pays for the transfer costs must also control the rate of transfer of labor.*

Wages and prices adjust to different payment mechanisms to bring about the same socially optimal rate of labor transfer. Even if wages are not fully flexible, the socially optimal rate of transfer may still be achieved by charging the costs to the employer in the contracting sector. Furthermore, under the current system, laid-off workers are paid UI benefits on the condition that they actively search for alternative

employment. Although this requirement is enforced with varying vigor in the states, it is designed to ensure that workers are, indeed, transferred to the expanding sectors at a socially optimal rate.

When the agent who pays for the adjustment costs does not control the rate of layoffs or hiring, there tends to be a large, nonoptimal adjustment of labor, or high structural unemployment. Since the government is usually not able to control the rate of transfer of labor, payment of the adjustment costs by the government (financed, for example, from general revenues) is nonoptimal. It may be argued that government financing is justified, to the extent that markets bring about *too slow* an adjustment. However, we conclude that, in general, experience rating (charging the costs of unemployment back to the contracting employers) generates socially beneficial results. This conclusion reinforces the finding that, with only temporary layoffs, increases in the degree of experience rating tend to lead to improvements in the allocation of resources.

Third, when layoffs are permanent, payroll taxes are not an ideal way of implementing experience rating. Temporary layoffs leave the taxable payroll (that is, the tax base) more or less unchanged, while permanent layoffs reduce the taxable payroll. Suppose, for example, that a firm's layoffs increase and that the UI benefits received by the laid-off workers are charged to the firm's account. If the layoffs are temporary, the taxable payroll remains more or less constant, and tax payments increase after a lag. If, by contrast, the layoffs are permanent, the taxable payroll and, hence, the firm's tax payments fall immediately. After a lag, the firm's tax rate and tax payments may rise to reimburse partially the UI system. In the limiting case, when the firm goes out of business, its taxable payroll and tax liabilities fall to zero. Thus, the charged benefits can never be recovered.

Our analysis shows that, under both systems of experience rating, UI tax liabilities are less than the benefit costs of permanent layoffs. In particular, when the firm is and remains at the maximum or minimum tax rate, it receives a *tax reward* for laying off workers permanently. This is the very opposite result to that intended by experience rating.

When the firm's long-run position is on the experience-rated portion of the tax schedule and the maximum tax rate applies only temporarily, then the reserve ratio method of experience rating, because of its longer memory, tends to generate a higher ratio of taxes to benefit costs

than is true with the benefit ratio method. In other words, the reserve ratio method tends to internalize a higher proportion of benefit costs than is true with the benefit ratio method.

We conclude this book with suggested economic policy changes. These recommendations are designed to increase the degree of experience rating and the degree of internalization of the costs of unemployment. Some of our policy suggestions have been made before: increasing or abolishing the maximum and minimum tax rates and shortening the lag between benefit charges and tax increases would improve the performance of the systems.

Our relatively new policy suggestions refer to the reserve ratio method of experience rating. First, positive balances in the UI trust fund should be treated as part of the employer's assets, and negative balances should be considered as liabilities. Second, upon bankruptcy, the firm's positive or negative balance in the UI trust fund should be counted as part of business assets or liabilities. Moreover, the UI trust fund ought to be allowed to claim reimbursement for part or all of the firm's UI liabilities in bankruptcy proceedings. Third, interest should be paid to the firm on its positive balances and charged on its negative balances. Together with the abolition of the maximum and minimum tax rates, these provisions could ensure the complete internalization of the costs of permanent as well as of temporary layoffs.

Much of the analysis underlying this study is abstract and mathematical. In our exposition we have attempted to present the arguments and principal findings first in intuitive terms and then more formally. We hope that this structure, which inevitably leads to some duplication, makes the research meaningful to a larger readership than would be the case with a tight mathematical presentation.