EBRI ISSUE BRIEF

EMPLOYEE BENEFIT RESEARCH INSTITUTE • 1920 N Street, NW/Suite 520/Washington, DC 20036 • (202) 659-0670

May 1983 #18

EMPLOYMENT TERMINATION BENEFIT PROGRAMS: THEIR EFFECTS ON TAXPAYERS, WORKERS' ATTITUDES, LABOR SUPPLY, AND THE OVERALL ECONOMY*

As a result of employment termination, job layoffs, plant closings, illnesses, disabilities, and work accidents, a large number of persons find themselves unemployed. Private, Federal, and state and local government programs share a responsibility for providing economic relief to those experiencing such hardships.

During the last thirty years, employment termination benefit programs have escalated in number, and they have expanded their levels of benefit payments. In 1950, benefits from these programs--excluding all retirement benefits--totaled $3 billion or 2 percent of wages and salaries. In 1980, they were nearly $70 billion--about 5 percent of total wages and salaries. This rapid growth has caused concern over program affordability and efficiency.

BENEFIT OVERLAPS

Many employment termination programs have waiting periods, maximum benefit durations, or both; these are intended to restrict the length of time during which benefits can be paid. Such program features may result in <u>sequential</u> benefit overlaps. The sequence may be deliberate; e.g., during a recession, a worker may first receive regular state unemployment insurance benefits for twenty-six weeks and next receive Federal-state extended benefits for an additional thirteen weeks. Or, the sequence may result from separate

* This issue brief summarizes material in a new EBRI publication entitled <u>Employment Termination Benefits in the U.S. Economy</u>. Research for this book was conducted by Dr. Wayne Vroman of the Urban Institute. The book discusses policy issues associated with employment termination benefit programs in the United States. Problem areas are identified, and proposals for reforming the existing system are examined. Primary issues considered are: (1) overlapping benefits resulting from a lack of program coordination; (2) inequities in income replacement rates for persons with different salary histories, in different industries, or in different areas of the country; (3) program funding problems; and (4) labor supply disincentives that cause some unemployed persons to delay reemployment. Twenty-eight separate public and private programs are considered. Their interrelationships and impact on worker behavior, taxpayers, and the overall economy are examined.

applications to different programs; e.g., a worker may apply for and receive state unemployment insurance benefits and later apply for and receive food stamps. Sequential benefit overlaps are common for those who experience long-lasting unemployment and disability.

Benefit overlaps may also simultaneously occur among termination or disability programs, and between either of these and income-conditioned transfer programs. For example, unemployed persons may simultaneously receive state unemployment benefits and supplemental unemployment benefits (SUBs). Among disability programs, Social Security Disability Insurance (SSDI) benefits can overlap with benefits from nine other disability programs.

Based on a survey of research which focused on the prevalence and magnitude of important benefit overlaps, the following observations can be offered:

(1) Of those who received unemployment insurance benefits in 1980: (a) 5 to 7 percent also received SUBs, Trade Adjustment Assistance (TAA) benefits, or both; (b) 5 to 10 percent also received retirement benefits; and (c) 15 to 20 percent also received food stamps.

(2) Among people with long-term disabilities, SSDI is the most prevalent form of employment termination benefits. SSDI beneficiaries are more likely than unemployment insurance beneficiaries to receive benefit overlaps. An estimated 40 to 50 percent of SSDI beneficiaries receive benefits from at least one other program.

(3) For beneficiaries who are ages fifty-five to sixty-four, it is difficult to distinguish among those who are unemployed, disabled, or retired. These persons may apply for retirement benefits as well as job termination or disability benefits.

(4) The extent of simultaneous and sequential benefit overlaps is lower than its potential prevalence. If all unemployment insurance recipients who are eligible for income-conditioned transfers exercise their rights, total program costs will increase. Furthermore, a greater number of persons will receive benefits that replace a very high proportion of the earnings they received prior to job termination.

Multiple benefits and high-income replacement rates (i.e., the portion of employment income replaced by benefit programs) are linked, but they are not necessarily synonymous. A single program such as the intercity railroad or redwood program may provide 100 percent replacement of lost wages. Alternatively, combined unemployment insurance and food stamp benefits may replace only a small fraction of wage loss for high-wage workers who become unemployed.

BENEFIT ADEQUACY

Benefit adequacy is frequently assessed on the basis of income replacement rates. Income replacement rates are calculated in a variety of ways, however.

A thorough analysis of replacement rates should consider taxes, employee benefits, work-related expenses, multiple benefits, and potential earnings growth. Much of the available research does not consider all of these factors. Moreover, there are: (1) no micro analyses available on the income replacement rates for workers with short-term illnesses and disabilities; (2) only a few studies of replacement rates for workers with long-term disabilities; and (3) only a small number of studies on workers who are displaced from jobs due to plant closings, technological change, and industrial relocations. Replacement rates for long-term disability cases are the most difficult to calculate. This results because long-term disabled persons experience multiyear earnings losses, and there are problems in evaluating their predisability and postdisability potential earnings growth.

Despite these shortcomings, the average micro replacement rates (i.e., total benefits from all programs as a proportion of net income losses for all beneficiaries) can be estimated for a number of programs. The rate for unemployment insurance is 45 to 50 percent, for short-term illness and disability is 65 to 75 percent, and for long-term disability is 50 to 55 percent. Note, also, that a large proportion of workers do not receive benefits because they are not covered (especially for short-term illnesses); or they are not eligible because they voluntarily left their previous jobs. If nonbeneficiaries are included in the calculations, the average replacement rates for unemployment insurance and short-term illness and disability are 30 to 50 percent lower.

Various groups of unemployed and disabled persons receive different income replacement rates. In some cases, benefits replace more than 80 percent of a person's net income loss. For example, SSDI's redistributive benefit formula ensures very high rates for low-wage, disabled workers. When such benefits are tax free, they can produce income replacement rates which exceed 100 percent of income loss.

As a result of high replacement rates, benefit equity and labor supply issues have arisen. The following policy changes have been suggested to reduce the occurrence of high replacement rates:

(1) Tax benefit income; e.g., all SSDI and workers' compensation benefits could become at least partially taxable.

(2) Impose maximum replacement rates on benefits; e.g., limit SSDI benefits to a flat 40 or 50 percent replacement rate of some maximum wage level.

(3) Require benefit offsets among different programs; e.g., implement benefit offsets among various disability programs and among various disability and unemployment programs.

BENEFIT FINANCING

In 1978, employment termination benefits represented four cents of each employee compensation dollar. The combined state unemployment insurance, state workers' compensation, and SSDI programs cost more than $47 billion. The next largest program, public employee disability insurance, cost $5 billion. Employer payments were $55 billion or 75 percent of the $73 billion total for all employment termination benefits.

The size of the various components that make up employee compensation is changing. Cash pay is declining and employee benefits are increasing. Expenditures for retirement programs and paid leave continue to be the largest categories; but expenditures for employment termination benefits are growing. They are now roughly equivalent to combined expenditures for life, accident, and health insurance.

Whether employers, employees, taxpayers, or consumers bear the ultimate burden of payroll-related benefits is not clear. Companies may shift these costs "forward" to consumers by raising prices. Or, they may shift costs "backward" by reducing employee cash wages or the costs of other production inputs. It appears that employers are more able to shift the costs of private plans backward than the costs of employer payroll taxes, which support public plans. Available research suggests that employers avoid most payroll-related benefit costs through a combination of forward and backward shifting.

<u>State Unemployment Insurance</u>

In recent years, state unemployment insurance programs have experienced serious funding problems. Factors contributing to these problems include:

(1) Important recessions in 1970-1971, 1974-1975, and 1980-1982. Peak-to-trough annual unemployment rates increased by 2.4 percentage points between 1969 and 1971, 3.6 percentage points between 1973 and 1975, and 3.9 percentage points between 1979 and 1982.

(2) Since 1971, employer payroll taxes have financed the Federal-state extended benefit program as well as the regular state unemployment insurance program.

(3) Many employment opportunities have shifted from the North to the South and West. The effects of the three recessions combined with movement of jobs have caused long-term as well as cyclical unemployment problems in the northern industrial states. This problem is aggravated by the generally liberal unemployment insurance programs in these states, which have resulted in higher-than-average beneficiary ratios and/or weekly benefits.

Benefit obligations have exceeded annual payroll tax revenues in several important state programs. Consequently, revenues must be increased, benefit payments must be restricted, or both. To develop effective policies, decision makers must determine an appropriate level of unemployment insurance within each state and across the country. Among the available policy options are:

(1) <u>Increase Revenues</u>

(a) Raise employer payroll tax rates.

(b) Increase the maximum taxable wage base and link it to a national wage index.

(c) Implement a policy of sharing tax revenues across individual state systems.

(d) During recessions, supplement payroll tax revenues with Federal general revenues.

(2) Restrict Benefits

(a) Expand the initial waiting period to two weeks, and eliminate benefit payments which retroactively cover this waiting period.

(b) Increase future benefit maximums at a slower rate than they have been increased in recent years.

(c) Subject lower levels of benefits to Federal income tax.

(d) Raise monetary eligibility requirements and increase benefit disqualification rates.

(e) Place greater restrictions on eligibility for extended benefits.

Since short-term unemployment does not cause substantial economic hardship, increasing the initial waiting period may be a better way to restrict benefits than reducing eligibility among the long-term unemployed. Unless new policies are implemented, many state unemployment insurance programs will continue to have trust fund deficits and funding problems.

Social Security Disability Insurance

SSDI's funding problem has been attributable to: (1) rapid growth in the number of beneficiaries between 1970 and 1976; (2) the diversion of 1980 and 1981 SSDI revenues to another part of the Social Security program--the Old-Age and Survivor Insurance (OASI) trust fund; and (3) indexing features which caused both contributions and benefits to rise with high inflation in the 1970s. However, given the tax rate increases of the 1977 legislation and the recent decrease in the number of beneficiaries, the SSDI trust fund will probably grow during the 1980s.

ECONOMIC EFFECTS OF EMPLOYMENT TERMINATION BENEFITS

The payment of employment termination benefits can affect labor availability, and it can affect the overall economy. Benefit programs that replace high proportions of earnings produce incentives for certain persons to discontinue working and for others to prolong benefit duration periods.

Some researchers estimate that state unemployment insurance programs increase the overall unemployment rate by about 20 percent--i.e., the 1979 unemployment rate of 5.8 percent may have been only 4.9 percent if labor supply disincentives had not been operative. By lengthening unemployment benefit periods, emergency measures may also raise overall unemployment. A number of program changes could reduce these effects. For example:

(1) Subject employers to more severe experience rating. If employers must absorb the full cost of nominal unemployment payments for workers they have laid off, the number of unemployment occurrences might decline.

(2) Reduce minimum benefit duration periods to ten-to-twelve weeks. Since some unemployment insurance programs in large industrial states have long minimum benefit duration periods, unemployment periods for such workers could be shortened.

(3) Reduce very high replacement rates; e.g., tax all state unemployment insurance benefits as ordinary income under Federal personal income tax and eliminate dependents' benefits.

Male Labor Force Participation

Men are participating less in the labor force. Three possible explanations are: (1) Older men may be responding to increased availability and generosity of disability and early retirement benefits. (2) Men may be responding to reductions in the quantity and quality of jobs available. It may be particularly difficult for older men affected by plant closings and relocations in the northern industrial states to find alternative jobs at comparable wages. (3) Workers' attitudes toward leisure and unemployment are changing.

All three explanations suggest that the labor supply will continue to decline, and nonworkers will continue to make increased use of public and private benefit programs. What can be done to reverse these trends? If the changing availability and generosity of early retirement and disability benefits are responsible for labor supply reductions, restructuring and restricting such benefits could help. If there is a shortage of attractive job opportunities, a period of sustained economic expansion may induce some beneficiaries to become reemployed. Additionally, the government might use its equal employment opportunity policies to reduce discrimination of older male workers. If changing work attitudes are responsible, resources could be directed toward assuring that disability determinations are objective and appropriate.

UNEMPLOYMENT INSURANCE AS AN ECONOMIC STABILIZER

Historically, unemployment insurance has acted as an automatic stabilizer of household income, and it has contributed significantly to national economic stability. According to some research, however, its role is modest when compared with personal income taxes. Some unemployed persons are not eligible for benefits, others exhaust their benefits, and others receive low benefits. Additionally, some persons continue to work, but their hours and, therefore, their wages are reduced. For these reasons, unemployment insurance replaces only 20 percent of the wages that are lost during recessions.

A number of policy changes could increase the economic stabilizing effects of unemployment insurance benefits. For example, liberalizing benefit levels and maximum benefit duration could enhance this program's macroeconomic stabilizing effects. Such changes, however, would increase program costs and would work against recent changes that have aimed at reducing unemployment benefits.

CONCLUSIONS

In improving and strengthening our private and public benefit programs, policymakers will have to consider the social adequacy as well as the individual equity of benefit payments. Thus, new policies should attempt to reduce the occurrence of needlessly high replacement rates, but they should not eliminate replacement rate variation altogether. In addition, revenues and costs must be balanced to ensure program solvency and reliability. There must also be an attempt to reduce labor supply disincentives, while preserving the role of unemployment insurance as an automatic economic stabilizer.

The Employee Benefit Research Institute's Education and Research Fund (EBRI) was established to contribute to the expansion of knowledge in the employee benefit field. The Education and Research Fund is tax exempt under section 501(c) (3) of the Internal Revenue Code and is not a private foundation. Individuals, corporations, companies, associations and foundations are eligible to support EBRI's work through tax-deductible contributions.

EBRI's policy forums, research studies, issue briefs, pamphlets and other publications aid public and private sector decision makers, managers, the press and the general public in formulating and articulating positions on employee benefit issues. As health and retirement issues receive increasing attention, EBRI strives to make effective and responsible contributions to public policy.

RETURN TO: EBRI, 1920 N Street, NW/Suite 520/Washington, DC 20036 (202) 659-0670

EBRI NOTES, a bimonthly newsletter, includes information about: 1) newly released employee benefit statistics; 2) brief summaries of EBRI's ongoing research studies and forum discussions; and 3) reviews of outside research and publications.

ISSUE BRIEFS, published monthly, offer summary information and critical analysis of evolving employee benefit issues and trends.

EBRI's sponsors automatically receive an annual subscription to *EBRI Notes/Issue Briefs*. Others can subscribe to these publications for $100 annually.

☐ I would like information on becoming an EBRI sponsor.

☐ I would like to subscribe to *EBRI Notes/Issue Briefs*. My check for $100 is enclosed.

NAME **TITLE** **TELEPHONE**

STREET ADDRESS **CITY** **STATE** **ZIP CODE**

ORGANIZATION **TYPE OF ORGANIZATION** **AREA OF INTEREST**

Articles published in Notes and Briefs do not necessarily represent the views of EBRI's sponsors, and they are not intended to support or oppose any legislation before Congress. Reproduction is granted provided proper attribution is given.

EBRI

EMPLOYEE BENEFIT RESEARCH INSTITUTE
EDUCATION AND RESEARCH FUND
1920 N Street NW/Suite 520/Washington, DC 20036

Address Correction Requested
Return Postage Guaranteed

Nonprofit Organization
U.S. Postage
PAID
Washington, DC
Permit No. 3968