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### Myopia, Fiscal Federalism, and Unemployment Insurance: Time to Reform UI Financing

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# **Myopia, Fiscal Federalism, and Unemployment Insurance:**

## **Time to Reform UI Financing**

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### **Abstract**

As commentators and Congress have recognized, the U.S. system of financing its unemployment insurance program is seriously dysfunctional. Reform proposals, however, do not fully diagnose the causes of current failures. In particular, other commentators neglect the role of fiscal myopia in state officials' failures to save for future UI needs. For instance, reformers mostly propose offering rewards or penalties that will take effect only far in the future. These incentives have only small effects on myopic officials.

I show here with a simple model of time-inconsistent preferences that alternative mechanisms (detailed herein) that would offer immediate incentives would be considerably more cost-effective. This result also implies that the chance to forgive current state debts to the federal government represents an irreplaceable opportunity to leverage ex ante incentives; Congress should not forgive these debts without demanding significant state progress towards future stability.

### **Introduction**

In keeping with a spurious but popular misreading of two Chinese characters (e.g., Kennedy 1959), the U.S. system of unemployment insurance ("UI") financing faces both an historic crisis and also an irreplaceable opportunity for fundamental reform. State UI trust funds---the segregated accounts held by the federal government for use in paying state UI

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claims---are empty in many states, and the states are collectively in arrears to the federal government by more than \$40 billion. (Vroman 2011). Members of Congress, the administration and several knowledgeable commentators suggest forgiving the states' debts in exchange for changes to the financing system that would supposedly prevent future defaults. However, I argue here that these proposals have overlooked a significant weakness of the existing system, and suggest some additional options that would better remedy that fault.

In particular, existing proposals neglect the significant role of fiscal myopia, or the tendency of state-level actors to behave short-sightedly when setting state budgets. State actors both rationally expect to leave office or relocate before long-term investments pay off, and also may lack the personal or institutional willpower to sacrifice today for the benefit of tomorrow. The administration's proposals almost exclusively provide states with ex post incentives to save for future UI demands, and these incentives are likely to be ineffective in influencing myopic officials. In contrast, I suggest ex ante reforms that would exploit state-official myopia in a way that encourages greater savings, such as by bribing officials to commit now that future officials will begin saving.

Myopia also explains the urgency of getting UI reform right, right now. Forgiving the state's debts is one of the few major ex ante incentives available to the federal government. If Congress forgives the debt without exacting the right kinds of promises from states, it will have squandered a unique opportunity.

The remaining parts of this article flesh out these points in greater detail. Parts 1 and 2 offer background on the UI system. Part 3 describes the ways in which the current system departs from a normatively ideal financing structure. Part 4 examines the reforms proposed by others, while Part 5 offers some additional suggestions that may better fit the temporal dynamic of state savings.

## **1. Role of Unemployment Insurance in the Economy Generally**

Unemployment insurance is a major factor both for individual households and the economy as a whole, especially during recessions. Asymmetric information generally prevents households from being able to purchase private insurance against loss of work unrelated to injury. (Chiu & Karni 1998). Although households can self-insure by building up a "buffer" of precautionary savings, that approach is obviously difficult for workers who have not yet reached substantial earnings power, or who have recently encountered other financial difficulties that depleted savings. The transaction costs of saving and investing may also be substantial -- for example, many households make very poor decisions in their long-term savings strategies. Similarly, many struggling households do not have ready access to affordable credit to substitute for savings. Recent studies confirm these predictions, finding

that unemployment insurance adds significantly to the amount of income-smoothing that private arrangements would permit. (See, e.g., Chetty 2008, Kroft & Notowidigdo 2011).

In the aggregate, UI can be a significant source of consumer demand during recessions. Given its income-smoothing function, we should expect that households receiving UI will tend to spend, not save. Most estimates find accordingly that government expenditures on UI have multipliers of 1.6 or higher, with some exceeding 2.0, making it among the most stimulative of all possible counter-cyclical tax or spending choices. (Congressional Budget Office 2010, Vroman 2010 at 48). Other estimates suggest that UI-driven demand during the recent recession accounted for .8% of GDP, reducing the impact of the recession by about 10% of the downturn on average. (Goolsbee 2010 at 5, Vroman 2010 at 45-49). There was, though, very significant variation in UI efficacy across states (Vroman 2010 at 49-51), reflecting the varying local rules for UI administration, as I will detail in a moment.

Even these eye-opening approximations of UI's recession-fighting power miss its contribution to the household demand of families that do not actually receive UI. As noted, households can substitute for the absence of UI by building up a buffer stock. Thus, in the absence of a robust UI system, workers who anticipate a potential shock to household income, such as might occur during a recession, would reduce household spending. (See Engen & Gruber 2001 for evidence that increased UI reduces household savings). This effect has also been observed in other safety-net programs, such as health insurance. (Gruber & Yelowitz 1999). Adequate UI programs therefore help to prop up consumer demand when economic dark clouds gather.

## **2. Structure of Unemployment Insurance in the United States**

The U.S. UI system is jointly financed and administered by the states and the federal government. (A useful overview of the system is NELP 2010). Unemployment benefits are paid for by unemployment insurance taxes, which are nominally imposed on employers. Both state and federal governments impose their own UI taxes, although the federal government collects both and holds each state's proceeds in a Trust Fund account. By federal law, employers are experience rated, so that employers whose workers file more successful claims pay a higher rate of tax.

States have considerable control over UI benefits. Although subject to certain federally-defined floors, states are free to define what constitutes an "eligible" recipient of UI benefits; typically workers who depart their job voluntarily and without compelling personal need are ineligible. State bureaucrats rule on eligibility decisions.

Funding for benefits varies depending on the length of separation. States pay the entirety of the costs of short-term unemployment insurance benefits from their Trust Fund

accounts. States and the federal government share the costs of medium-term benefits, and the special “extended” benefits enacted by ARRA (and other similar emergency long-term benefits provided in the past) have historically been borne entirely by the national government. (GAO 2010). The federal tax, or “FUTA,” is also used for two other main purposes: to aid states in the costs of claims administration, and to help shore up struggling state balances.

The per-employee burden of federal and state taxes depends on a combination of each government’s tax rate and “taxable wage base.” The base is defined as a fixed amount of each employee’s salary. For example, the federal UI tax base is \$7,000; each employer pays the applicable federal rate (which can increase if the state is not in compliance with all federal requirements) on the first \$7,000 earned by each employee. State wage bases vary but by federal law must at least equal the federal base.

States that deplete their available UI funds can borrow from the federal fund. Modest interest charges apply to states that take more than a year to repay, and if a state fails to repay within two years then employers in the state are subject to an extra charge of twenty-one dollars (.03% of the wage base) per employee per year in federal UI taxes. (NELP 2010). The twenty-one dollar figure is a small fraction—less than 10% on average—of the tax most employers pay. In short, the federal UI fund offers reinsurance to states through a common pool, with only a mild penalty, payable in the future, for overuse of the insurance.

The federal penalty for default has not changed since 1983, and, of course, the real value of twenty-one dollars has declined significantly since then. During that time span, states’ contributions to their own funds have declined, and state borrowing against the federal fund has increased sharply. (GAO 2010). Many states have explicitly shifted to a “pay-as-you-go” policy, which means that the state is simply refusing to save in advance for recession-driven spikes in UI claims. In effect, states are planning to borrow against the federal fund and deferring to the future the costs of repaying the resulting loans.

### **3. Normative Questions About the U.S. System**

As other commentators have recognized, the system just described is problematic under a standard fiscal federalism analysis. Many of the macroeconomic returns of UI expenditures accrue outside of the state paying the benefits, so state-level funding produces a race to the bottom. (ACUC 1996: 10, 28, 37. A pithy review of the historical evidence is Charles C. Steward Machine Co. v. Davis, 301 U.S. 548, 586-88 (1937)). Further, the legal incidence of UI taxes fall on employers, who as a general matter are more mobile than their workforce.<sup>2</sup> Commentators

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<sup>2</sup> The UI tax is not a benefit tax for employers. To the contrary, by improving workers’ position in the event of labor bargaining-related layoffs, the UI system likely redistributes rents from capital to labor. UI may also increase the wage level needed to induce the marginal worker to re-enter the workforce. And, even if businesses did view

suggest that in the long run the economic incidence of these taxes is shifted to workers, but that in part reflects the greater elasticity of employer decisions, including decisions about where to locate.<sup>3</sup> (Anderson & Meyer 2000). As a matter of public choice theory, UI is more nearly a public good than UI taxes are a public bad, and so political opposition to these taxes is likely more intense than political support for the corresponding benefits. This is especially the case when one side has greater bargaining power, as is often the case when mobile employers face off against relatively immobile workers. The theoretical prediction, then, is that states will tend to under-invest in UI, especially given that many of its benefits are in large measure externalities for any single state.

Federal efforts to shore up inadequate state financing appear to have compounded the problem of state under-investment. (ACUC 1996: 12, Galle & Stark 2012). Again, states with insufficient balances in their own Trust Fund accounts can borrow against the national Fund. The resulting moral hazard encourages states to underfund their own accounts. Most funding pressure has derived from decreasing real tax burdens, rather than from more generous benefits. (Vroman 2011).

The UI system's penalties on excessive state borrowing appear to have been ineffective at curbing this moral hazard problem. One has to admire the cleverness of the penalty-system design. By imposing the penalty on employers, rather than the state's budget, the UI designers anticipated by 50 years the theoretical insight that state legislators may view an end to corporate pain as their own private good and budget pain as a public bad.<sup>4</sup> (In other words, employers lobbying to end the penalty tax are more likely to command legislators' attention than the loss of state treasury dollars would.) What is less clever is the failure to index the penalty for inflation. As Galle & Stark (2012) argue, the fact that the real value of the borrowing penalty has declined steadily since 1983, paired with corresponding increases in state borrowing, is at least consistent with a growing moral hazard story. More careful quantitative work on this front would be helpful.

### **3.1 Questions About the Timing of State Incentives**

The timing of the UI repayment and penalty structure is also problematic in several different ways. As other commentators have pointed out, the requirement that states repay their loans within a relatively short period after borrowing means that many repayment obligations will be triggered either during a recession or during the state budget doldrums that

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UI as a benefit to them, they may myopically prefer to avoid investing in a UI system they may later relocate away from, as I discuss below.

<sup>3</sup> Employers can claim a federal deduction for their state UI taxes, however. IRC § 170; IRS Pub. 535 § 5.

<sup>4</sup> In all likelihood, though, this design choice was the product of legal rules, not political-theory insights. In the 1930's it was unclear if the federal government could constitutionally enact a tax or other financial incentive whose legal incidence fell on states. See, for example, the discussion in *United States v. Butler*, 297 U.S. 1 (1936).

almost inevitably follow. (ACUC 1996). The result is often an increased tax on hiring, or significant cuts in UI benefits, at a time when the state's employment climate is already strained. Moreover, hyper-rational consumers who anticipate these predictable negative shocks in state UI benefits may cut back on consumption and increase precautionary savings during the recession itself.

Another important timing aspect others have seemingly overlooked is the fact that current UI penalties---and many of the stronger incentives proposed by others---are imposed only after the state has borrowed, and long after the time the state has failed to accumulate an adequate UI reserve. If state officials behave myopically, and assign greater value to immediate rewards than to future penalties of similar present value, then an incentive system that fails to account for that present bias will significantly under-incentivize savings.

Fiscal myopia is a well-documented phenomenon in many other contexts. Most states do not make adequate contributions to their budget stabilization or "rainy day" funds, even though that is the normatively ideal tool for borrowing-constrained governments to deal with the business cycle. (Sobel & Holcombe 1996). States underfund public employee pension funds, and charge inadequate premia to cover likely claims in most of their public disaster-insurance programs. (Mitchell & Smith 1994, Chaney et al. 2002, Cummins 2006:358-60). In each of these contexts, there is at least some reason to doubt a full federal bailout, suggesting that short-sightedness, and not simply moral hazard, is at work.

Political explanations for myopia are fairly straightforward. Officials know that they have a limited time in office. If the voting public were perfectly far-sighted, the short time horizon of officials might be stretched, as entrepreneurs representing future interests would offer rents in exchange for long-term fiscal planning. But entrepreneurs, too, have limited horizons, and future, unallocated, budget liquidity is largely a public good. Further, at the subnational level, private actors know that they have the option of relocating, and so should discount future payoffs to account for that possibility.<sup>5</sup>

Myopia can also be a psychological phenomenon. Impatience has been widely documented in household finance decisions, and even in decisions by firm managers. (See Frederick et al. 200 for a review). If both voters and officials are impatient, then there are few obvious market-clearing mechanism by which present-biased officials would be driven from office.<sup>6</sup>

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<sup>5</sup> Thus, residents with other large sunk investments, such as homeowners, may be relatively more attentive to long-term interests than average. (Fischel 2001).

<sup>6</sup> Admittedly, though, an exception to this general point may be playing itself out in Europe, where the shorting of public debt that cannot realistically be repaid has arguably contributed to leadership turnovers in Greece and Italy. But that is a process that was more than a decade in the making.

### 3.2 Back-Door Nationalization?

It might be argued that the general failure of UI penalties to prevent state borrowing is a second-best outcome, in that it is part of a gradual shifting of UI financing wholly to the federal level. Given the race-to-the-bottom dynamic in state-level UI taxation, and the benefits of fiscal risk diversification, collecting revenues at the national level might be the most efficient result. (ACUC 1996: 29). If states simply underfund their own accounts and borrow extensively from U.S. funds, and these borrowings are periodically forgiven or repaid with little interest, then in effect we have federal financing. Of course, it is federal financing of a strange design, with current federal revenue targets aimed at meeting only emergency demand, rather than being set at a level that would cover the full cost of all national UI needs.

In my view it is unclear whether any major move towards nationalizing UI financing would be normatively attractive. Obviously nationalizing financing while leaving benefit determinations in the hands of states would be likely to increase state demand for UI benefits, since the collective cost of financing would be a common pool from the perspective of all local actors. Arguably this is a desirable outcome, at least in the short run, if one thinks that interjurisdictional competition has suppressed UI benefits below the socially optimal level. Some period of benefits exuberance might be a useful way of playing catchup. Similarly, if one thinks that even national policy makers would set benefits levels too low---for example, because of the public good nature of safety-net spending and the legal incidence of the tax on powerful businesses---then a mechanism that created offsetting incentives to over-produce might conceivably better approximate the ideal point.

In the parallel debate over health insurance, a similar but conceptually distinct argument against nationalization (e.g., in Galle & Stark 2012a) is that the moral hazard effects of federal funding might change the ways that states regulate the business of health care. Historical and well-entrenched U.S. arrangements give states considerable substantive power over the regulation of health care providers, and in the presence of federal funding, they have little incentive to use that power to hold down costs. A comparable argument here would be that states inevitably will retain considerable authority over the employer/employee relationship, and indeed over the general rate of growth of their local economies. Federal UI funding allows states to regulate without concern for the costs of paying for dislocated workers, and perhaps therefore to make riskier policy choices than they would otherwise.

These possibilities raise two sets of additional questions. On the one hand, it may be that moral hazard would result in little behavioral change, because state officials would internalize the costs of unemployment in other ways, such as through voter discontent. On the other hand, some changes, such as encouragement to take on more risky, and therefore perhaps more innovative, policy might actually be moves in the right direction.



For now what I think it is safe to say is that the current system is not designed to accommodate the various pressures that greater federal financing would create. Uncertainty about the timing and degree of federal assistance, as well as pressure from constituents and bond-rating agencies, will likely lead state officials either to cut benefits or raise taxes during recessions. (For historical evidence, see ACUC 1996: 6). Therefore, further slippage towards federalization is probably undesirable, unless we can determine with confidence that nationalization would bring better outcomes.

#### 4. Existing Proposals to Reform UI Funding

My argument here is that a successful “fix” for the UI funding system has to account for all three of the potential sources of pressure I’ve just described. Current proposals focus instead only on moral hazard and pure exit pressure. If myopia is an important factor, then these proposals may fail to bring fiscal stability to UI. Given that serious reform seems to occur at best generationally, it is unwise to leave unresolved a large potential hole in the program.

##### 4.1 Ex Post Remedies

One major way in which extant reform proposals neglect the role of myopia is in the preference of some for what I will call “ex post” incentives. For example, Leachman et al. (2011) and Vroman (2009) offer the possibility of paying states higher rates of interest on money deposited into their UI Trust Fund accounts. The Advisory Committee on Unemployment Compensation (1996: 11) proposed funding this incentive with small penalties on low balances. Vroman also suggests a rate structure that rewards states that make progress towards adequate fund balances. Interest deposited into Trust Fund accounts, however, is unlikely to fully compensate present-biased state officials for the subjective time value of their money, since the interest is useful only during some future crisis in which payouts exceed contemporaneous revenues.<sup>7</sup> Subsidies usable immediately by the biased official can be set at a lower level than subsidies that must be delayed.

To see this point, first consider a simple model of present bias. Suppose that we represent an agent’s subjective present value of future consumption as  $\beta\delta c$ , where  $\delta$  is a standard discount rate, such as is produced by a market rate of interest, and  $\beta$  is a special discount, between 0 and 1, that the individual applies only to future consumption. A rational, unbiased actor allocating resources across time maximizes current consumption subject to future consumption,  $u_1 + \delta u_2 + \delta^2 u_3 + \dots \delta^n u_n$ . But the present-biased actor excessively discounts future consumption, maximizing instead  $u_1 + \beta \delta u_2 + \beta \delta^2 u_3 + \dots \beta \delta^n u_n$ . Or, if excessive

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<sup>7</sup> In addition, fund balances more generally have only weak incentive effects on individual officials. Fund balances are a public good, while lobbying by state employers can create private goods or bads for officials who must set tax rates and benefits. For evidence, see Galle (2011).

discounting compounds in the manner of ordinary interest (for example, because the extra discount is due to some uncertain factor, such as death or relocation, whose probability increases with time), the present-biased actor maximizes  $u_1 + \beta \delta u_2 + \beta^2 \delta^2 u_3 + \dots \beta^n \delta^n u_n$

Now suppose that officials derive utility from providing public goods. Then, holding tax levels constant, and assuming debt can be refinanced annually, a present-biased official's utility from savings, such as in the UI Trust Fund, can be represented as  $\beta^n \delta^n u_n(g) + u_0(D(i_1 - i_2)) - u_0(\delta^n g)$ .  $D$  is the amount of outstanding debt,  $i_1$  and  $i_2$  are interest rates before and after adjustments for the higher Trust Fund balance (for simplicity, assume the debt is paid off after one period), and  $\delta^n g$  is the amount of current funds that must be saved to have  $g$  goods in period  $n$ .<sup>8</sup> Unbiased officials can be represented similarly, but will lack the  $\beta^n$  term.

Now let  $\alpha$  represent a matching grant to the jurisdiction in some proportion between 0 and 1. The subsidy changes the official's present utility to  $\beta^n \delta^n u_n(g) + u_0(D(i_1 - i_2)) - u_0((1 - \alpha)\delta^n g)$ . If the utility function in period  $n$  is the same as in the present, then by simple algebra, the subsidy level needed to induce savings for an unrestricted grant is:  $\alpha_u \geq 1 - \beta^n - ((D(i_1 - i_2)) / \delta^n g)$ . Unless both  $\beta$  and the projected debt savings are zero, alpha will be a number smaller than one, which means that the federal government will not need to provide 100% of the funds saved.

In contrast, if the subsidy is allocated to future expenditures, such as through Vroman's interest-rate bonus payments, then an official's present utility can be given as  $\beta^n \delta^n u_n(g + (\alpha \delta^n g)) + u_0(D(i_1 - i_2)) - u_0(\delta^n g)$ . Then the subsidy need to induce savings if the subsidy is directed to the trust fund is:  $\alpha_r \geq (1 / \beta^n) - 1 - ((D(i_1 - i_2)) / \beta^n \delta^n g)$ . If we compare the two inequalities for the two different subsidies, and solve through, we get  $\alpha_u = \beta^n \alpha_r$ . That is, the size of the subsidy amount for an immediate or unrestricted subsidy is heavily discounted relative to the size of a subsidy that cannot be consumed until some later period.

Delayed penalties are similarly ineffectual, in comparison to more immediate punishment, when applied against officials who behave as though they are hyperbolically discounting. This in part may explain the ineffectuality of the UI system's existing penalties, which are triggered only in the event the state cannot quickly repay borrowed funds---that is, long after the state has made the decision not to deposit enough money in its Trust Fund to avoid the need to borrow. Proposals to tinker with the borrowing system, as in the suggestion in Vroman (2009) to deny loans to states that have not saved adequately, may likewise be less effective than expected because contemporaneous officials will greatly discount the expected cost of any future penalty.

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<sup>8</sup> I assume that Trust Fund contributions allow states to borrow at lower rates, presumably because such contributions will improve credit ratings. See Wagner (2004) for evidence on the effect of rainy-day fund balances on credit ratings.

The present-bias problem cannot necessarily be solved simply by changing the target of incentives from officials to employers or voters. Officials are not the only UI system players who may be present biased. For example, mobile businesses may behave as though they have a higher time-discounting factor because they expect that they will exit in response to unwanted changes in local conditions. Individual employees may have psychological reasons for neglecting the future, as an extensive empirical literature now documents. (Again, see Frederick et al. 2004 for a review).

Finally on this front, it should be mentioned that threats of penalties that will payable during or shortly after a recession are generally not credible, for reasons that are already fairly well understood. Penalties will have to be imposed at a time when the state is already struggling financially, and those struggles damage outsiders. Political opposition to penalties is therefore likely to be sharpened not only from the payers, but also from their trading partners, as well as from federal officials who depend on good economic performance for reelection, lenders who hope to avoid defaults by the payers, insurers of the lenders, and so on.

#### 4.2 Conditional Forgiveness of Existing Loans

A set of options that better accounts for the myopia problem are suggestions to leverage states' existing loan balances. More than 30 states presently have outstanding UI loans, with total balances exceeding \$40 billion, and projected to rise to \$60 billion by 2013. A number face the possibility of penalty payments this year as well. Leachman et al. (2011) propose that the federal government offer to waive some or all of these loans in exchange for state commitments to agree to more adequately fund their Trust Fund accounts. Critics reportedly are skeptical that states would agree to terms that could justify the substantial revenue cost to the government. However, these arguments underestimate the possibility that current state officials may place relatively low value on the autonomy of their successors.

To see this, return to the simple model of the previous section. Suppose that a present-biased agent maximizes utility with a fixed subjective discount for future events,  $u_0(g) = \beta \delta^n u_n(g)$ . For simplicity assume that utility functions in the present and in period  $n$  are identical, and represent a linear, one-for-one transformation of dollars to utility. If the prevailing interest rate is 10% then in order to have \$100 available for consumption in period two, the actor must forego  $(C = \frac{100}{1.1})$ , or \$90.90, in period one consumption. By definition, the discount rate is  $\frac{1}{1 + \text{interest rate}}$ , so  $\delta = .909$ .

Now start with officials with  $\beta = 1$ . This is the situation implicitly posited by critics of the conditional loan forgiveness proposals: no excessive time-discounting. Under these conditions, states with preferences inconsistent with Trust Fund savings would commit to savings only in

the amount they were actually paid. This amounts to full federal funding of the UI program. Or, given the limited size of current loan balances, it implies only minor state commitments to future savings.

Next suppose a present-biased actor with  $\beta = .5$  faced with the choice whether to save now in order to have higher consumption later. Thus the subjective value of the period two consumption, viewed from period one, is only  $.5(.909)(100)$ , or \$45.45. To convince the actor to save in period one for period two, we would have to offer a subsidy of  $\$90.90 - \$45.45 = \$45.45$ . States would save twice as much as the federal government forgives.

Now return to the model, but assume our goal is to convince the actor to agree *in period one* that he will forego consumption *in period two* to consume \$100 in period *three*. The actor's subjective period one value of having \$100 for period three consumption is  $.5(.909)^2(100) = \$41.31$ . Our actor again must save \$90.90 in period two to have \$100 available one period later. What is the apparent cost, in period one, of giving up \$90.90 in period two? Well, since period two consumption is discounted by  $\beta$ , the actor perceives the present value of the cost to be  $.5(.909)(90.90) = \$41.31$ . Thus the period one actor needs *no subsidy at all* to agree to the future savings, since the subjective costs and benefits of saving and consuming are identical. Under these assumptions state would agree to any federal target savings even without the incentive of loan forgiveness.<sup>9</sup>

Alternatively, and probably more realistically, suppose that biased discounting worked more like the traditional discount rate, such that the period one discount on any subsequent period were  $\beta^n \delta^n u_n$ . Then, if all else remains the same, the period one subjective present value of having \$100 in period three would be  $(.5)^2(.909)^2(100) = \$20.66$ . Period two would be unchanged. Thus the subsidy needed to induce the period one actor to commit to period two savings would be  $\$41.31 - \$20.66 = \$20.66$ . Not zero, but less than half the subsidy needed if the savings were to be in period one. States would save more than four times as much as the federal government forgives.

In short, the model implies that states may be surprisingly willing to promise future fiscal rectitude in exchange for comparatively modest present benefits. In more intuitive terms, an elected politician may actually be eager to limit the room for maneuver of the rival who drives her from office. Alternately, consider that individuals often exhibit demand for "commitment devices" to help them overcome their own impatient, and in some cases have been observed to pay a premium for commitment services. Signing onto UI finance reform may be a desirable commitment device for some state-level actors.

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<sup>9</sup> Presumably the reason that states would not enact these forms of savings plans themselves is because they lack the political will or constitutional authority to self-commit.

### 4.3 Carrots or Sticks?

One major caveat to the loan forgiveness plan, as well as to other proposals to reward states for saving, is that such “carrots” may be less efficient than a similar-sized penalty. These two options are often similar in their marginal substitution effects, but can also diverge considerably on other grounds. Galle (2012) summarizes these differences, many of which are familiar to students of the debate over pollution pricing. Prior literature, however, almost entirely neglects the parallel case of positive externalities---such as counter-cyclical spending by states---a gap I tried to fill in that project. In brief, carrots and sticks diverge in their impact on income effects, in their need for treasury dollars, in their distributive impact, in the psychological response of human actors, and in the incentives they create for strategic behavior. Most of these factors clearly favor sticks over carrots, except that in the positive externality context the choice is much closer.

As I acknowledged there, however, all of the analysis, including mine, focused on government efforts to incentivize private actors. Many important considerations in the choice between carrots and sticks could well look different when the target is another sovereign. Consider revenues. In general, carrots are less efficient than sticks because they require the expenditure of public funds, resulting in deadweight loss from taxation. However, if the carrot is being transferred to another sovereign, the incentive payment may displace tax-generated funds for the recipient government. The efficiency question then would seem to depend significantly on which government has the less distortive tax base.<sup>10</sup>

Although there is still much work to be done in thinking through how to design price instruments to influence sovereign governments, preliminarily it looks as though carrot-type incentives in a federal UI financing system are defensible. That is a noticeable difference from most cases, in which carrots are clearly dominated by sticks. Carrots for UI seem to score well on the income-effect and revenue criteria. States where businesses can collect federal UI incentives will attract greater investment, expanding the UI tax base and facilitating savings. Wealthier state citizens may also have a greater demand for government services, which perhaps would reduce the extent to which states would face pressure to offset any contributions to UI savings with cuts in general revenues. And raising the federal dollars spent on carrots is likely to result in considerably lower deadweight loss than state-level taxes falling on capital.

At the same time, it should be kept in mind that using rewards rather than punishments for states also has some potentially severe incentive effects for states. Carrots can crowd out

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<sup>10</sup> I don't want to suggest that this is the only consideration. For example, it might be the case that each government could revise its tax rules to become more efficient, and that the payment of a carrot also alters each entity's incentives to do so.

savings by infra-marginal states. And this crowd-out is not necessarily limited to UI. States may point to the UI precedent in their decisions in other areas where they must save for the future, such as in setting their “rainy day fund” policy, public-employee pensions, or disaster insurance. States that might be inclined to take sensible forward-looking approaches may hesitate, in the hopes that by dragging their feet they may trigger some federal reward. To the extent that the federal government can credibly threaten sticks in these cases, states would have the opposite set of incentives.

#### **4.4 Broaden the Federal Tax Base?**

Another worthwhile proposal by the current administration, as well as many others (Leachman et al. (2011), Vroman (2009), ACUC 1996:13) would increase the wage base for federal tax purposes, and continue to adjust it upwards over time. Recent proposed legislation, The UI Solvency Act of 2011 (S. 386) also would have expended the base in exchange for partial forgiveness of state Trust Fund loans. Again, FUTA has since 1983 been imposed on the first \$7,000 of each worker’s wages. By federal law, state wage tax bases must equal or exceed the federal base. Leachman et al. argue that raising the federal base would therefore help shore up state finances by effectively broadening the base in those states that have not adjusted their bases to keep up with inflation. Leachman et al. suggest lowering federal rates to leave total federal UI tax burden on employers unchanged, so it appears their primary goal is to achieve state revenue increases.<sup>11</sup>

The logic of this claim is a bit unclear. States can also adjust their rates downward to take account of any federally-required base broadening. So perhaps the presumption is that inertia in at least some states would lead to accidental revenue increases. That is certainly sometimes the case in other instances, such as when federal tax changes impact mirror state-law provisions. But in others, states do respond promptly, as in the case of certain federal accelerated depreciation deductions, which a number states quickly disclaimed. (Mason 2011: 1019-21). Probably most states would eventually adjust their rates downwards, but if there

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<sup>11</sup> In general, broadening a tax base and lowering rates can be efficient, since it is the marginal rate of the tax that primarily determines its distortive effects. That is not necessarily the case for FUTA. The federal minimum wage puts lawful full-time workers at well above \$7,000. FUTA therefore operates as something like a flat tax on full-time work, and therefore impacts only the extensive margin of labor/leisure decisions. (Part-time workers are effectively ineligible for benefits in most states. See Lester 2001: 346-55 for an explanation.) Broadening the FUTA base above the minimum-wage threshold of \$14,500 might actually increase the tax’s distortive effects. At that point, assuming that some of the incidence is passed on to workers, it also begins to affect labor/leisure decisions along the intensive margin, i.e., the relative amount of effort invested or wages reported.

Another virtue of broadening the base is that it would improve the progressivity of the tax. (ACUC 1996: 13). That seems like a good goal irrespective of other reasons for base-broadening, but I note that the regressivity of the tax could be (but isn’t really currently) offset by a more progressive benefit structure. Benefits are capped, making them more progressive, but the cap in most states affects workers making far more than \$7,000.

were annual federal increases there would be lag periods in which state revenues would begin to rise.

To my mind the greater impact of the federal base adjustment proposal is its effects on state moral hazard. The FUTA base is also the tax base used to determine the size of the federal penalty for debtor states. Raising that figure significantly, and then indexing it for inflation, would significantly increase the expected and actual costs of empty state Trust Funds for businesses. Whether this is a desirable result depends on whether one favors sticks over carrots.

If continuing expansion of the federal wage base is deemed desirable, there remains the question about whether to do so in a way that is revenue-neutral. Presumably one reason for indexing the tax base federally is to ensure that federal revenues grow at roughly the same rate as payout needs. On the other hand, revenue-neutrality obviously makes any base-expansion plan more politically palatable for businesses. Leachman et al. do not explain how they would simultaneously index the base while also maintaining revenue neutrality. One possibility would be to counter-index the UI tax rate --- that is, providing for automatic reductions in the tax *rate* as the base increased. While the U.S. has little direct experience with automatic rate changes, a number of commentators have explored the implementation of self-adjusting rates, especially in the energy tax context. (E.g., Merrill & Schizer 2010).

## **5. Other Options**

The proposals on the table so far hardly exhaust the universe of possible reform options. I will offer a few others, with the caveat that we still understand the political economy of UI financing imperfectly. My suggestions aim to do a better job of targeting all three of UI's "M" problems---moral hazard, mobility, and myopia. But tackling all three simultaneously involves tradeoffs; if we knew more precisely the situations in which one problem was more acute than the others, we could tailor remedies to those instances.

### **5.1 A Federal Penalty Tax**

One option that seemingly has not received serious attention is to impose an additional federal tax on employers in states with severely inadequate Trust Fund balances. This "penalty tax" could be pooled with the state's own-source funds, or, conceivably, could be treated as federal money and deposited in the federal account. My preliminary view is that the second, federalization, option is needlessly harsh. State officials are already likely to be highly attuned to complaints from businesses subjected to a penalty tax --- indeed, in the 80-year history of UI, no state has ever triggered the federal penalty applicable to employers in states that fail to meet basic program rules. Nor will returning the money to the state soften the anger of taxed

employers, since the state's Trust Fund is effectively a club good for the state's employers: none have strong incentives to care about Trust Fund balances.

Either way, the penalty tax on employers accounts for all three UI failures. Most penalties for containing moral hazard are not credible, since they would have to be imposed while the state is in fiscal need. Or, if the penalty is deferred until after the state has recovered, it is so far in the future from the perspective of current planners that its incentive effects are greatly diminished. Penalties contemporaneous with the decision to save or not do not face these difficulties. Further, if imposed directly on employers they avoid whipsawing the state official between her federal incentive to save and employer political pressure to cut taxes.

Galle & Stark (2012) argue against a similar form of federal "mandate" in the context of state contributions to rainy-day funds. We worried that federally-required savings would not likely be flexible enough to reflect states' idiosyncratic needs for budget stability, and that mandating that states save some set portion of their revenues would distort state tax efforts. For example, on the latter point, we suggested that a savings requirement could encourage states to privatize some services, so that the denominator of the mandatory amount would shrink.

Our concerns there, however, do not translate cleanly to the UI context. First, diversity and experimentalism aren't much in play at low levels of UI funding contributions. While states may have varying needs for savings, the penalty could be capped at a level of savings --- say, 25% of the average expected annual cost of benefits --- that every state would need to have a meaningfully self-funded UI program. States would still be free to determine how best to meet that target. Second, since the penalty is not assessed against the state at all, there is no obvious distortion in the state's incentive to set its own tax rates.

## **5.2 Employer Tax Discounts**

A reciprocal tax supplement for employers could substitute for or be paired with any penalty. Employers would see a lower total UI tax burden in states where Trust Fund balances exceeded a target threshold, such as 75% of national-average expected annual cost. To avoid cliffs, both penalty and supplement could be phased in, perhaps with a region in between where neither would apply. For example, a portion of employers' state taxes could be made deductible from their FUTA payments.<sup>12</sup>

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<sup>12</sup> There is currently a statutory cap on the amount of funds the Labor Department can hold in the federal accounts, and on a number of occasions the federal government has distributed excess funds back to states. Typically, though, these payouts have not been structured to achieve any particularly useful policy goal. It seems more sensible to use excess federal revenue to aligning state incentives properly.



The supplement differs from earlier proposals to reward states with higher Trust Fund interest rates in two key respects. For one, it is enjoyable immediately, reducing the myopia problem. And, because it goes to firms and not the general budget, it more likely represents a private good for state officials. However, both of these features could perhaps be replicated with other forms of grants to the state. For example, as Galle & Stark (2012) suggest, federal incentives could be paid directly to the state as unrestricted funds, allowing officials to identify the most politically effective way of buying off constituencies opposed to savings.

The choice between these alternatives is therefore an example of where it would be helpful to have better information about how UI funding goes wrong at the state level. There is a potential tradeoff here between filling state coffers and maximizing the political efficacy of the federal incentive. Without better information, it is difficult to say which is the best choice. Probably the best approach in the near term is to use a series of pilot projects to test each of the different alternatives.

### **5.3 Revenue Targets Rather than Fund Balances**

An admitted problem with all of my proposals so far, as well as with a number of those offered by others, is that states can potentially satisfy their conditions without actually increasing counter-cyclical spending. In particular, states can meet any incentive keyed to their Trust Fund balance by cutting payouts rather than increasing revenues. Indeed, the Advisory Council on Unemployment Compensation found that federal incentives for state fiscal solvency were a contributing cause of state benefit cuts in the 1980's. (ACUC 1996: 2, 6). Further, if account-balance targets are experience rated in some way, then states have incentives to hold down expenditures in order to make their future targets easier to reach.

Maintenance-of-effort rules are a traditional solution to this problem, but few commentators believe that they have ever really been successful. (Inman & Rubinfeld 1997). Evidence suggests that governments can game MOE rules by using off-setting transfers outside the budget area controlled by the rules. For instance, Gordon (2004) finds that school districts receiving federal funds to educate indigent children, and who are legally barred from reducing own-source education funds, instead cut school lunches, transportation assistance, and other forms of aid for needy families who benefit from the federal money. Even if MOE rules actually worked, they present the problem that it rarely will be desirable to freeze in place the set of rules states happened to have in place when the federal MOE rule went into effect. That is especially the case if, as a practical matter, federal "floors" also prove to be ceilings.

One alternative, then, would be to replace fund-balance targets with some other metric that is more difficult for states to game. A possibility would be what I will call a "PART," or population-adjusted revenue target. Federal incentive-program administrators would calculate

the national average per capita savings contribution states would need in order to make acceptable progress towards federally-defined adequate savings. For example, the Department of Labor could calculate the total national shortfall in state Trust Fund balances, and then determine the total national contributions needed to reach safe levels in some reasonable period, such as four years. Each state's incentive structure would then be determined according to how well it met its share of the national per-capita annual contribution needed.

To further account for regional variation and moral hazard, states could also be experience-rated, with adjustments to PART contributions to reflect historical patterns of job turnover in the state. For more precision, this economic-conditions adjustment could instead track the numbers in the MSA's within the state, with portions of each MSA's results allocable to the state by the portion of state population in each such MSA. In this way, states with, say, migrant workers or large numbers of bureaucrats would need to save more or less, respectively.

It might be objected that focusing only on revenues, rather than fund balances, will have the effect of rewarding bad savers and penalizing good savers. That is true, but not necessarily a flaw. States that already have strong records of savings --- and, to be frank, at present those are rather few --- are effectively infra-marginal, and so in fact should receive a lower subsidy. States with persistently poor savings records may have few resources or face especially intense intra-jurisdictional fiscal competition, thereby meriting more federal aid.

Another distortion the PART system brings, and again one that is desirable in my view, is that it tends to encourage moral hazard in the provision of UI benefits. Given the political economy of sub-national UI funding I outline earlier, there is reason to suspect state decisions about benefit levels will fall far below the national optimal. I doubt even extensive federal co-funding would fully offset this underprovision. For example, in the Medicaid context, there is evidence of a race to the bottom in state spending, notwithstanding very generous federal matching grants. (Bailey & Rom 2004).

Finally, it is worth noting that one other tool for propping up benefits provision could be some degree of federalization of eligibility determinations. Vroman (2001) finds that most state competition is expressed not in benefit *levels*, but rather in reciprocity rates. Southern and Mountain West states, in particular, have notably lower levels of separated workers who successfully claim benefits. Vroman suggests that this difference is driven largely by claims administration, such as the decisions of administrative law judges. I would add that states may also use various "ordeal" mechanisms to reduce the rate at which workers attempt to claim benefits, such as making filing burdensome or socially awkward.

The question here is largely one of federalism values. Financing is a secondary consideration, because federal UI taxes already pay for a significant portion of states' costs of claims administration. Rather, the issue is that states can, within some limits, define what makes a separated worker eligible. Federal administration of claims would likely significantly diminish this flexibility. Since states almost certainly will continue to control many other significant aspects of the employer-employee relationship, separating the two bodies of law may lead to awkward gaps or misalignments. For instance, workers might be considered to be terminated "for cause" under state employment law but not federal claims decisions, or vice-versa, leading at least to confusion for the general public. And, although the value of state experimentation has been overstated (see Galle & Leahy 2008 for a complete critique), there may still be some value in observing different approaches to claims administration over time. (ACUC 1996: 30). Still, if the PART proposal proves unworkable, federal claims administration deserves serious consideration as an alternative way to reconcile federal incentives with state pressure to cut benefits.

### **Conclusion**

Many existing proposals to reform UI financing are smart, thoughtful, and take the magnitude of the program very seriously. I've argued that there is reason to worry that many, however, won't work because they fail to account for the important role myopia typically plays in state fiscal decisions. The major exception is the suggestion, reflected in recent proposed legislation (S. 386) to forgive current outstanding loan balances in exchange for state commitments to get their acts together. What my analysis adds to that effort is a sense of urgency. There are few available ex ante incentives for affecting state behavior. Forgiving loan balances is one of them. If Congress excuses states without getting meaningful forward-looking reforms in exchange, it will have lost an historic opportunity to safeguard UI.

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