Where Liberty Comes First

POLICY BRIEF

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MODERNIZING UNEMPLOYMENT INSURANCE

By Aaron Hedlund

KEY TAKEAWAYS

- America's antiquated unemployment insurance system is in need of modernization. Missouri is partially constrained by federal laws but still has some latitude to make positive reforms.
- Prohibiting benefits from exceeding paychecks, tying benefit duration to better measures of labor market slackness, streamlining short-time compensation programs that enable job attachment, reducing the penalty for part-time work, and broadening the unemployment insurance tax base to enable lower tax rates would promote job creation and faster recoveries.
- Missouri can tackle unemployment insurance fraud by participating in multistate data-sharing platforms and by expanding new-hire reporting requirements.

ADVANCING LIBERTY WITH RESPONSIBILITY BY PROMOTING MARKET SOLUTIONS FOR MISSOURI PUBLIC POLICY

BACKGROUND

In early 2021, the federal government passed the multi-trillion-dollar American Rescue Plan Act (ARPA) with the supposed aim of resuscitating the economy. The problem: the patient—the U.S. economy—was alive, recovering well, and in no need of bad fiscal medicine. By early 2021, gross domestic product was back on track to its pre-COVID trajectory, and the unemployment rate had already fallen from its peak of 14.7% in April 2020 to 6.3% and was still declining. Another measure of labor market tightness—the ratio of unemployed persons to job openings—registered at 1.3 before the implementation of the ARPA. For perspective, since these data started being collected in 2000, the *only* pre-COVID years in which this ratio averaged a value lower than 1.3 were the boom years of 2017, 2018, and 2019.

Given the tightness of the labor market in early 2021, it was a baffling decision for the federal government to inject trillions of dollars of borrowed money, particularly when much of that money went to providing excessively generous unemployment benefits that were paying workers more to remain on the sidelines than they would earn by returning to work, thus kneecapping producers' ability to hire. Since this policy debacle, Americans have paid the price—literally. Inflation reached 40-year highs in summer 2022 and remains troublingly high. The cumulative effect of this persistent inflation has been a decline in purchasing power for the typical family of about $4,000. At the same time, businesses have faced extreme difficulties finding workers when forced to compete against government benefits. Even though the benefit extensions have since run out, they continue to cast a long shadow because of the amount of savings that people were able to accrue from the benefit payments, thus allowing them to delay their return to work.

The twin crises of debilitating inflation and crippling labor shortages are connected—and unemployment insurance is the critical link. Although the ARPA turned on several spigots of money to artificially stimulate demand, unemployment benefits were unique in that they also undermined supply by discouraging work. Earlier in 2023, the Show-Me Institute released a comprehensive report on the structural problems with the existing unemployment insurance system, proposed some bold long-term reforms, and also identified initial steps that Missouri can take at the state level to reform its own unemployment insurance system without running afoul of federal rules.[1] This brief explains the logic of these state reforms.

MISSOURI UNEMPLOYMENT INSURANCE REFORMS

Before Missouri can accomplish any substantive policy reforms to its unemployment insurance system, it must modernize its information technology (IT) and accounting systems to ensure that technical capability is not a limiting factor. During the COVID-19 pandemic, when federal policymakers were looking at ways to temporarily increase the generosity of weekly unemployment benefits to help workers remain current on their bills while they were living under lockdown orders, the National Association of State Workforce Agencies cited antiquated state IT systems as a reason not to simply raise the replacement rate. Lifting this rate from, say, 50% to 80% would have still meant that workers would earn more money by returning to their jobs once able to do so. Instead, because of antiquated IT, the federal government added a flat $600 supplement to weekly benefit payments, causing many claimants to receive more from benefits than their previous paychecks. To prevent anything like this episode from ever happening again, and to facilitate reforms, Missouri needs a comprehensive examination of its computer and accounting systems to ensure they are capable of executing a wide range of potential policy reforms.

In no particular order, below is an initial slate of worthwhile reforms.

Reform: Prohibit Benefits from Exceeding Paychecks

Current policy stipulates a maximum weekly benefit that is a percentage of a worker's previous earnings, subject to a fixed nominal cap of $320. This cap does not adjust for inflation, and the law makes no explicit mention of the possibility of federal supplemental payments

pushing a worker's total benefit amount well above the prescribed maximum. To simultaneously address the ill effects of inflation and preempt future misguided federal interventions, the state can tie the weekly benefit cap to the average annual wage in Missouri and specify that, in the event the federal government institutes supplemental unemployment benefit payments, the state will offset its own weekly payments as needed to ensure that the total benefit a claimant receives does not result in a replacement rate above 100%.

Reform: Shorten Benefit Duration and Strengthen the Link with Economic Conditions

The duration of regular state-provided unemployment benefits currently ranges from 13 to 20 weeks, depending on Missouri's unemployment rate. Unfortunately, recent economics research finds that extending benefits repeatedly based on the unemployment rate can perpetuate high joblessness and slow the pace of recovery.[2] Although the primary purpose of unemployment insurance is to cushion the blow from job loss, it also tends to delay the job search process and, worse still, it discourages job creation by forcing employers to compete with government-provided benefits. Thus, tying the duration of benefits to the unemployment rate can create a partially self-fulfilling phenomenon where a high unemployment rate causes benefits to be extended, which curtails job search and job creation, thereby perpetuating high unemployment.

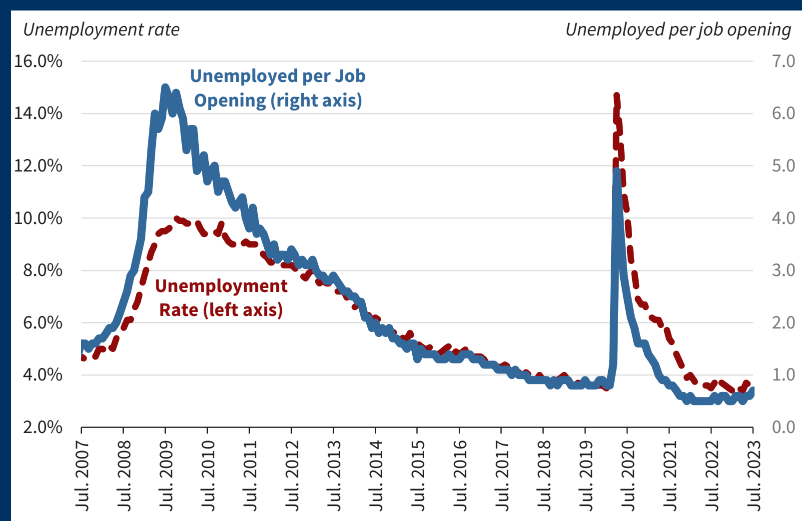
Missouri can make two improvements to mitigate this problem. First, it can follow the research and tie the duration of benefits to the ratio of unemployed persons to job openings instead of the unemployment rate.[3] Second, the state can modestly but meaningfully reduce the duration of benefits—especially during good economic times—to enhance job creation. A growing body of economics research has found positive labor market effects from previous reductions in benefit duration.[4]

Figure 1 below provides an instructive comparison of the Great Financial Crisis (GFC) that began in 2007 and the COVID-19 recession. During the GFC, the unemployment rate peaked at around 10%, and the ratio of unemployed persons to job openings exceeded six at its worst. Both of these measures of labor market slackness took several years to recover to robust levels, in no small part because of bad federal policy—including excessive unemployment benefit extensions. Research

Figure 1

Labor Market Slackness: Great Financial Crisis vs. COVID-19

Multi-year unemployment benefit extensions slowed the labor market recovery following the 2007–2009 crisis.



Source: Bureau of Labor Statistics

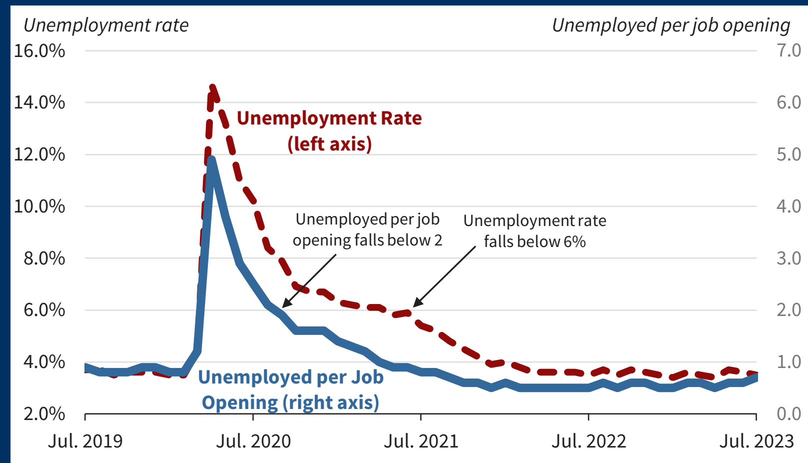
suggests that the recovery could have proceeded at a noticeably quicker pace had there been a faster normalization of benefit duration.

Switching attention to the COVID-19 recession, both measures of labor market slackness exhibit dramatic spikes. Perhaps the most immediate contrast between COVID-19 and the GFC is the speed with which the labor market slackness measures recover—owing in part to the different nature of the economic shocks as well as the early federal interventions (e.g., through the Paycheck Protection Program and the Employee Retention Tax Credit) to promote stronger labor market attachment. Less obvious, but importantly for the purposes of this discussion, the figure shows that the ratio of unemployed per job opening has fallen much more quickly than the unemployment rate.

Figure 2

Comparison of Benefit Triggers

Unemployed per job opening—a better measure of slackness—had returned to healthy levels by fall 2020, arguing against any further “stimulus” or benefit extensions.



Source: Bureau of Labor Statistics

Figure 2 zooms in on the COVID-19 recession and makes the divergence even more clear. Even though the unemployment rate did not fall below 6% until May 2021—not so coincidentally, right around the time several states announced that they would soon be terminating extended unemployment benefits—the unemployed to job openings ratio fell below 2 (the same degree of tightness experienced by the U.S. economy in 2014) in September *2020*. In other words, for all practical purposes, the labor market was no longer slack by early fall 2020, and the economic case for further unemployment benefit extensions could no longer be made. Unfortunately, another year would pass before unemployment benefits returned to their pre-COVID generosity and duration. By that time, the seeds of the labor shortage had been sown. Going forward, Missouri can do its part to avoid a repeat by tying benefit duration to the ratio of unemployed to job openings instead of the unemployment rate.

Reform: Reduce Fraud from Improper Payments through Data Sharing

Unemployment insurance fraud occurs in several ways. For example, workers may misrepresent their job search activities or refuse to accept a suitable job offer. However, research finds that concealed earnings represent the lion’s share of fraud at over 60%.[5] This fraud occurs when an unemployed worker does not inform the unemployment office after receiving a new job—thus collecting benefits and a paycheck simultaneously. This type of fraud is especially easy to execute if a worker lives near a state border such that it is feasible for them to live and work in different states. This scenario is salient for Missouri considering that its two largest cities are both on state borders.

One immediate step Missouri can take to reduce

unemployment insurance fraud is to pursue participation in the National Association of State Workforce Agencies' State Information Data Exchange System (SIDES) and its Integrity Data Hub (IDH). SIDES facilitates electronic information transmission between agencies and employers regarding unemployment insurance claims, and the IDH is specifically designed to facilitate the detection of unemployment insurance fraud and improper payments.

Missouri can also follow Florida's lead by expanding new hire reporting requirements. In order to comply with federal law—specifically, the Personal Responsibility and Work Opportunity Reconciliation Act of 1996—Missouri has written into state statute that employers have 20 days to report new *employee* hires to the department of revenue. Recently, Florida has gone further by extending this requirement to the hiring of independent contractors that a "service recipient" (not technically an employer) expects to pay more than $600 over the course of the calendar year. This way independent contractors are not able to collect payments for their work while also receiving unemployment benefits. An ancillary benefit is that such an expanded reporting requirement would make it easier for Missouri to detect child support negligence.

Reform: Broaden the Taxable Wage Base to Allow for Lower Tax Rates

It is a well-established fact that tax codes with a broad base and a low rate are less economically damaging than tax codes with a narrow base and a high rate. Unfortunately, Missouri's unemployment insurance tax falls into the second camp. Currently, only the first $10,500 of a worker's wages are subject to the tax, which means that the state must charge higher rates to raise sufficient revenue to fund the program than it would if a greater share of wages were subject to the tax. An easy fix to this problem is for policymakers to set the top end of the taxable wage base equal to the average Missouri annual wage—which is over four times the amount of the current wage base—and then to recalibrate the rates to yield revenue neutrality, leading to dramatic rate reductions.

Reform: Streamline Short-time Compensation

Job loss during recessions has well-known short-term consequences—anxiety, loss of income, and thus lower consumer spending—but it also creates medium-term and long-term economic scars owing to labor market detachment. The longer that a worker is without a job, the greater the difficulty in generating job offers through labor market search. For this reason, the federal government implemented the Paycheck Protection Program during COVID-19 to help employers keep workers on the payrolls and to accelerate the re-hiring process for employees who were laid off. While COVID-19 was a unique event, the federal government has for years enabled states to implement short-time compensation (STC) programs that enable and encourage employers to reduce employee hours instead of headcount during temporary downturns. Germany's *Kurzarbeit* program follows a similar model and has been very successful at limiting unemployment spikes during recessions. Unfortunately, employer uptake of STC in the United States has consistently fallen below expectations, both because of narrow participation criteria in many states and because of red tape involved with the application and approval process.

Broadly speaking, federal law requires that employers submit a work-sharing plan to the state that explains how they will cut employee hours instead of engaging in layoffs, and then those workers can receive pro-rated unemployed insurance for the temporary loss in pay while continuing to show up to work. As with regular unemployment insurance, employers that participate can expect to face a higher unemployment insurance tax rate in the future—just as auto or home insurance premiums increase after a claim—but the tradeoff may still be beneficial to allow the business to make it through a rough patch.

As a condition for participation in Missouri's STC program, employers must cut hours by no less than 20% and no more than 40%, even though federal law allows these bounds to be 10% and 60%, respectively. In other words, Missouri's STC program is unnecessarily restrictive, thus pushing employers more in the direction of engaging in overt layoffs. A sensible reform is for Missouri to conform to the looser federal requirements.

In addition, Missouri state government gives itself up to 30 days to render a decision on an employer's STC application and up to seven days to approve subsequent changes requested by an employer to its worksharing plan. These delays disincentivize employer participation. Reducing these periods to ten days for initial approval and three days for approval of changes would increase the appeal of STC participation.

Reform: Reduce the Penalty for Part-time Work

Under current law, if a laid-off worker obtains a part-time job while continuing to search for full-time work, each dollar the worker earns (above $20 per week) is offset by a one-dollar reduction in unemployment benefits, thereby eliminating any incentive for laid-off workers to accept part-time work while maintaining their search for a full-time job. Missouri can partially mitigate this work penalty by reducing the offset from 100% to 50%. Under this reform, each dollar a part-time laid-off worker earns would lead to a 50-cent reduction in unemployment benefits.

Aaron Hedlund is chief economist for the Show-Me Institute.

NOTES

1. Hedlund, Aaron. "The Case for Modernizing Unemployment Insurance," 2023, Show-Me Institute Report.

2. Hedlund (2023). This report provides an extensive discussion of the literature with a more comprehensive list of references.

3. Mitman, Kurt and Stan Rabinovich. "Whether, When and How to Extend Unemployment Benefits: Theory and Application to COVID-19." *Journal of Public Economics,* 2021; Vol. 200.

4. Johnston, Andrew C. and Alexandre Mas. "Potential Unemployment Insurance Duration and Labor Supply: The Individual and Market-Level Response to a Benefit Cut." *Journal of Political Economy,* 2018, Vol. 126(6), pp. 2480–2522; Karahan, Fatih, Kurt Mitman, and Brendan Moore. "Micro and Macro Effects of UI Policies: Evidence from Missouri." 2022. Federal Reserve Bank of New York (working paper).

5. Fuller, David L., B. Ravikumar, and Yuzhe Zhang. "Unemployment Insurance Fraud and Optimal Monitoring." *American Economic Journal: Macroeconomics, 2015,* Vol. 7(2), pp. 249–290.

5297 Washington Place I Saint Louis, MO 63108 I 314-454-0647

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