# HOW TO SAVE UNEMPLOYMENT INSURANCE

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ABSTRACT

*Unemployment insurance is almost universally recognized as one of a government's best tools for fighting recessions, as well as an important source of relief for working-class families suffering temporary hardship. Unfortunately, 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 far in the future. These incentives have only small effects on myopic officials.*

*Building on work in behavioral economics by myself and others, I propose a set of new reforms that address the roles that both myopia and federalism have played in crippling the UI regime. For example, I suggest that state governments can be induced to "Save More Tomorrow," and that states should be obliged to opt out of federal default rules for when workers will be eligible for benefits. In addition, I show that any reform—such as all of those now on offer—based on the amount states currently have saved for future contingencies will likely only cause future cuts to UI, and propose alternative metrics to avoid this perverse result.*

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## INTRODUCTION

Unemployment insurance ("UI") is a key pillar of modern economies. In addition to serving as a vital safety net for working families, UI provides major counter-cyclical support for the economy during economic downturns, helping to reverse a recession's downward spiral of falling demand and additional layoffs.[1] Experience during the Great Recession, however, shows that the American UI system is crumbling, perhaps near collapse.[2] For all that UI benefits helped—estimates suggest they may have prevented as much as 10% of the damage from the slowdown—other features of the UI system were actually working to discourage new hiring.[3] And it is likely that developments over the past few decades crippled the UI benefit system, leaving it far less effective than it might have been, and worsening the nation's recent economic woes.[4]

This Article attempts to diagnose UI's failures and to provide some possible paths forward. While UI has received scant attention in legal academia,[5] and its financing system essentially zero attention, there is a general awareness in the policy community that something went badly wrong in 2009 and 2010.[6] My argument here will be that existing proposals for UI

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1. U.S. DEP'T OF LABOR, OFFICE OF UNEMPLOYMENT INS., UNEMPLOYMENT COMPENSATION: FEDERAL-STATE PARTNERSHIP 1 (2018); Cong. Budget Office, Opinion Letter on Unemployment Insurance Benefits and Family Income of the Unemployed, at 6–11 (Nov. 17, 2010); Walter Nicholson & Karen Needels, *Unemployment Insurance: Strengthening the Relationship Between Theory and Practice*, 20 J. ECON. PERSP. 47, 48 (2006).

2. MICHAEL LEACHMAN ET AL., *REBUILDING THE UNEMPLOYMENT INSURANCE SYSTEM: A DEFICIT-NEUTRAL PLAN THAT LIMITS TAX INCREASES AND MAINTAINS BENEFITS* 1 (2011), https://www.cbpp.org/sites/default/files/atoms/files/2-9-11sfp.pdf ("The systems for financing unemployment insurance . . . in many states are broken . . . ."); ANDREW STETTNER, SPEEDING THE RECOVERY OF UNEMPLOYMENT INSURANCE 5–6 (2016), https://s3-us-west-2.amazonaws.com/production.tcf.org/app/uploads/2016/03/14165019/speeding-the-recovery-of-unemployment-insurance.pdf ("The UI system faces a funding crisis that has made the safety net weaker than any time in its history.").

3. *See* discussion *infra* Part II.B.

4. *See* discussion *infra* Part II.A.

5. The only prior discussion of the UI financing system I could identify in the legal literature was Symposium, *Unemployment Insurance: Continuity, Change, and Prospects for Reform*, 29 U. MICH. J. REFORM 1 *et seq.* (1996). Other legal scholarship addresses the role of UI taxes as an incidental aspect of UI's role in society more generally. Gillian Lester, *Unemployment Insurance and Wealth Redistribution*, 49 UCLA L. REV. 335, 335 (2001); Frans Pennings & Paul M. Secunda, *Towards the Development of Governance Principles for the Administration of Social Protection Benefits: Comparative Lessons from Dutch and American Experiences*, 16 MARQ. BENEFITS & SOC. WELFARE L. REV. 313, 392–93 (2015).

6. Recognition that the UI system has serious flaws predates the Great Recession, as summarized in U.S. ADVISORY COUNCIL ON UNEMPLOYMENT COMP., COLLECTED FINDINGS AND RECOMMENDATIONS, 1994–1996 (1996), https://research.upjohn.org/cgi/

reform, while often thoughtful and worthy of serious consideration, have missed several important likely causes of UI's failures. I show that these proposals remain vulnerable to the same failings that have led UI to the brink, and offer instead some modifications to better reflect UI's underlying weaknesses.

One particularly important oversight is that existing proposals neglect the significant role of fiscal myopia, or the tendency of state-level actors to behave shortsightedly when setting state budgets. Most UI benefits are paid for through state taxes on local businesses.[7] 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.[8] Proposed reforms almost exclusively provide states with ex post (that is, delayed) incentives to save for future UI demands, and these incentives are likely to be ineffective in influencing myopic officials.[9] In contrast, I suggest ex ante reforms that would exploit state-official myopia in a way that encourages greater savings, such as by paying states to commit now that future state officials will begin saving.

In crafting my suggestions I draw on important recent theoretical and empirical work in behavioral economics.[10] Even if state officials are rationally myopic, I will argue, policy tools that have been developed to counter irrational myopia among individuals can readily be adapted for use in fiscal policy. In addition to current payments for future commitments, I also propose using opt-out defaults as a way of steering state officials to make the best choices, and explain why these defaults may be preferable to alternatives such as penalties or subsidies.

Another major difficulty with both UI law and proposed reforms is that they tend to incentivize states to cut benefits, even when further benefit cuts would tend to be bad for the country as a whole.[11] UI's financing system encourages states to accumulate money in a trust fund account when times

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viewcontent.cgi?article=1000&context=externalpapers [hereinafter "ACUC"] and U.S. GEN. ACCOUNTING OFFICE, GAO/HRD-93-107, UNEMPLOYMENT INSURANCE: PROGRAM'S ABILITY TO MEET OBJECTIVES JEOPARDIZED (1993), https://www.gao.gov/assets/160/153652.pdf.

7. CONG. BUDGET OFFICE, PUB. NO. 4525, UNEMPLOYMENT INSURANCE IN THE WAKE OF THE RECENT RECESSION 7 (2012).

8. Brian Galle & Kirk J. Stark, *Beyond Bailouts: Federal Tools for Preventing State Budget Crises*, 87 IND. L.J. 599, 608–09 (2012).

9. *See infra* text accompanying notes 163–180.

10. *See generally* Brian Galle, *Tax, Command . . . or Nudge? Evaluating the New Regulation*, 92 TEX. L. REV. 837 (2014); Brigitte C. Madrian, *Applying Insights from Behavioral Economics to Policy Design*, 6 ANN. REV. ECON. 663 (2014).

11. *See* ACUC, *supra* note 6, at 12.

are good, so that there is enough money available to pay benefits during recessions when benefit claims spike.[12] Unfortunately, all of the existing tools for encouraging positive trust fund balances allow states to choose whether to improve their financial condition by raising taxes, or instead by cutting back on promised benefits.

Many systematic features of law and politics put pressure on states to choose benefit cuts—including, as no one has apparently observed before, the fact that the federal government effectively taxes states on their benefit payments. As a result, the share of separated workers who receive UI benefits has fallen from more than 45% to less than 30%.[13] Other developed countries average more than double that rate.[14] This implies that, had UI been as robust as it was in the past, the most recent recession could have been softened by perhaps 15% or more, not 10%.

I propose mechanisms that aim to reverse these unwanted incentives for benefit cutting. Among other suggestions, I offer the possibility that any incentives a state is offered depend not on the proportion of its own promised benefits the state holds in its trust fund, as in current law, but instead on the per capita fraction of total national benefits the state's fund could afford to pay. The power of this measure, which I dub the "population-adjusted revenue target," or PART, is that no individual state could significantly change its PART by cutting benefits; only revenue increases would do. Of course, there are a number of plusses and minuses to such a scheme, as I discuss. In addition, I argue that a simpler step, repealing the effective federal tax on state benefits, would help remove the federal distortions that currently favor benefit trimming.

If I am correct that ex ante incentives are critical to successful UI reform, it is important that policy makers consider fixes to the UI system now, while the economy is still steady.[15] The next recession will be too late to enact many

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12. U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-15-281, UNEMPLOYMENT INSURANCE: STATES' REDUCTION IN MAXIMUM BENEFIT DURATION HAVE IMPLICATIONS FOR FEDERAL COSTS 10–11 (2015).

13. U.S. DEP'T OF LABOR, REGULAR PROGRAM INSURED UNEMPLOYMENT AS A PERCENT OF TOTAL UNEMPLOYMENT, https://oui.doleta.gov/unemploy/Chartbook/a12.asp (last visited Dec. 24, 2018); Laurie J. Bassi & Daniel P. McMurrer, *Coverage and Recipiency: Trends and Effects*, *in* UNEMPLOYMENT INSURANCE IN THE UNITED STATES: ANALYSIS OF POLICY ISSUES 51, 52, 63 (Christopher J. O'Leary & Stephen A. Wandner eds., 1997).

14. Wayne Vroman, Unemployment Insurance: Current Situation and Potential Reforms (Feb. 3, 2009) (unpublished manuscript) (on file with The Urban Institute).

15. *See* JASON FURMAN, U.S. COUNCIL OF ECON. ADVISORS, THE ECONOMIC CASE FOR STRENGTHENING UNEMPLOYMENT INSURANCE 1 (2016), https://obamawhitehouse.archives.gov/sites/default/files/page/files/20160711_furman_uireform_cea.pdf ("Unfortunately, people often

of the most promising policies. For example, states that run out of trust fund money can borrow from the federal government.[16] Forgiving these state debts in exchange for state commitments is one of the few major ex ante incentives available to the federal government. If Congress were to forgive future debt without exacting the right kinds of promises from states, it will have squandered a relatively unique opportunity. And, in the meanwhile, states continue to cut UI benefits—when North Carolina recently announced that it would shorten the maximum period of benefits, several other states followed.[17]

Part I of the Article offers a general introduction to UI and its financing in the United States. Part II describes UI's path to near-collapse during the Great Recession. These two initial sections will be familiar to other scholars who study UI. Part III offers my account of the underlying causes of the events described in Part II. Part IV then assesses existing proposals for UI reform in light of these fundamental problems, and argues that none adequately account for myopic state officials. Part V proposes a series of new potential reforms, and weighs their accompanying tradeoffs.

## I. ROLE OF UNEMPLOYMENT INSURANCE IN THE ECONOMY

Unemployment insurance ("UI") is a major factor both for individual households and the economy as a whole, especially during recessions.[18] In essence, UI is a government program jointly funded and administered by states and the federal government.[19] The federal government sets certain basic ground rules, and states can fill in most of the details.[20] States also determine whether workers and their employers have complied with state and federal rules.[21]

UI provides a partial replacement of wages for some recently-unemployed workers.[22] A worker who is fired, or is forced by certain compelling

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only pay attention to these issues at the wrong time: in the middle of a recession . . . . Instead, it is a discussion we should be having now while the labor market is strong.").

16. U.S. DEP'T OF LABOR, *supra* note 1, at 7.

17. U.S. GOV'T ACCOUNTABILITY OFFICE, *supra* note 12, at 4–5.

18. For example, the UI system paid out more than $150 billion in benefits during 2010, far more than any other non-health federal program. CONG. BUDGET OFFICE, *supra* note 7, at 5.

19. U.S. GOV'T ACCOUNTABILITY OFFICE, *supra* note 12, at 4.

20. *Id.* For an overview of differences in state program detail, see Nicholson & Needels, *supra* note 1, at 49–53. For a summary of the minimum rules imposed by federal law, see U.S. DEP'T OF LABOR, *supra* note 1, at 3–4.

21. U.S. DEP'T OF LABOR, *supra* note 1, at 1–2.

22. CONG. BUDGET OFFICE, *supra* note 7, at 5.

circumstances to leave, can claim benefits, while workers who quit voluntarily usually cannot.[23] In many states part-time workers are effectively ineligible for UI.[24] Eligible workers must submit a claim to a local unemployment office, and in most cases must show the office that they are available for and seeking a replacement job.[25] If a worker is found eligible, she is paid a fraction of her old wages, up to a (usually fairly low) statutory dollar-value cap; nationally, average benefits now hover around $300 per week.[26] Workers can only claim benefits for a limited period, twenty-six weeks in most states, although states also must provide "extended benefits" for an additional period when economic conditions worsen significantly.[27] This period has sometimes been extended further by Congress during recessions.[28]

Both state and federal governments impose taxes to pay for UI benefits and administrative costs.[29] In both cases, UI taxes are nominally imposed on employers, but economists believe that in the long run employers are able to pass the cost of these taxes on to workers in the form of lower salaries.[30] The federal government collects state and federal taxes and holds each state's proceeds in a Trust Fund account.[31] By federal law, employers are experience rated, so that employers whose workers file more successful claims pay a higher rate of tax.[32] Firms with very high experience-rated tax rates relative to their industry are less likely to be able to pass through these taxes to

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23. *Id.*

24. NAT'L EMP'T LAW PROJECT, PART-TIME WORKERS AND UNEMPLOYMENT INSURANCE 3 (2008), http://www.nelp.org/content/uploads/2015/03/parttimeui0304.pdf.

25. Christopher J. O'Leary, *State UI Job Search Rules and Reemployment Services*, 129 MONTHLY LAB. REV. 27, 27 (2006). Most claims can now be submitted remotely, rather than in person. *Id.* at 28.

26. CONG. BUDGET OFFICE, *supra* note 7, at 6.

27. U.S. GOV'T ACCOUNTABILITY OFFICE, *supra* note 12, at 4. Commentators believe that the triggering mechanisms for extended benefits do not do a good job matching EB periods to read periods of economic hardship. ACUC, *supra* note 6, at 3.

28. CONG. BUDGET OFFICE, *supra* note 7, at 5.

29. *Id.* at 7.

30. *Id.* at 13. Three states also collect a small fraction of UI taxes directly from employees. U.S. DEP'T OF LABOR, *supra* note 1, at 9. For discussion of some of the empirical uncertainties of the incidence of the UI tax, see Lester, *supra* note 5, at 382–84.

31. CONG. BUDGET OFFICE, *supra* note 7, at 5.

32. U.S. DEP'T OF LABOR, *supra* note 1, at 10. Experience rating is only partial in most states, resulting in higher unemployment. Nicholson & Needels, *supra* note 1, at 56–57.

workers, which means that experience rating creates real incentives for firms to reduce turnover. [33]

The source of funding for benefits varies depending on the length of separation.[34] States pay the entirety of the costs of short-term UI benefits from their Trust Fund accounts.[35] States and the federal government share the costs of medium-term benefits, and the special "emergency" benefits enacted by Congress during the Great Recession (and other similar temporary long-term benefits provided in the past) have historically been borne entirely by the national government.[36] 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.[37]

The per-employee burden of federal and state taxes depends on a combination of each government's tax rate and "taxable wage base."[38] The base is a defined as a fixed amount of each employee's salary.[39] 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.[40] State wage bases vary but by federal law must at least equal the federal base.[41]

With that brief introduction, let us now consider why this humble program has such a major role to play in the U.S. economy.

### *A. For Individuals*

Families are usually better off if they can move money from good times to bad times.[42] This is why we save for retirement, buy insurance, take out

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33. Patricia M. Anderson & Bruce D. Meyer, *The Effects of Firm Specific Taxes and Government Mandates with an Application to the U.S. Unemployment Insurance Program*, 65 J. PUB. ECON. 119 (1997).

34. CONG. BUDGET OFFICE, *supra* note 7, at 6–7. Various tax planning techniques have developed to help firms avoid experience rating, however. Charles C. Kearns, *State Implementation of the SUTA Dumping Prevention Act of 2004*, 11 ST. & LOC. TAX LAW. 105, 111–15 (2006).

35. *See* CONG. BUDGET OFFICE, *supra* note 7, at 6–7.

36. U.S. GOV'T ACCOUNTABILITY OFFICE, *supra* note 12, at 6–7.

37. CONG. BUDGET OFFICE, *supra* note 7, at 7–8.

38. U.S. GOV'T ACCOUNTABILITY OFFICE, *supra* note 12, at 7.

39. *Id.*

40. *Id.* at 11.

41. *Id.*

42. *See* JONATHAN GRUBER, PUBLIC FINANCE AND PUBLIC POLICY 29–30 (3d ed. 2010).

student loans, and have credit cards.[43] By "smoothing" the peaks and valleys of our income, we help to soften the pain of the worst times. This makes sense because money means more when we have less of it: for the poorest households, a thousand dollars is the difference between rent and homelessness, while for the richest it's a generous tip at a pleasant evening meal. Economic lingo dubs this the "diminishing marginal utility of wealth": each additional dollar increases our well-being by a little bit less.[44]

UI, like other forms of insurance, is a form of income smoothing.[45] In effect, workers accept lower salaries when they have a job in exchange for an income of more than zero when they are out of work.[46] For workers with important fixed expenses, such as the costs of sheltering and feeding their family, having replacement income during spells of unemployment represents an essential lifeline.[47]

It's generally agreed that if government did not provide UI, private markets would be unable to replace it.[48] Asymmetric information and adverse selection generally prevent households from being able to purchase private insurance against loss of work unrelated to injury.[49] That is, if insurers offered policies to cover against the risk of lost work, it is likely that most policies would be purchased by workers who perceived themselves at greatest risk. That could produce a "death spiral," familiar now from public discussions about the Affordable Care Act. Because so many high-risk workers would sign up, premiums would be high, so that low-risk workers would be unwilling to pay. That would drive premiums up higher yet, and so on. The UI system eliminates this problem by forcing every worker to "buy" insurance from the government.[50]

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43. *See* Martin Browning & Annamaria Lusardi, *Household Saving: Micro Theories and Micro Facts*, 34 J. ECON. LITERATURE 1797, 1799–800 (1996).

44. GRUBER, *supra* note 42, at 29–30; Shane Frederick et al., *Time Discounting and Time Preference: A Critical Review*, *in* ADVANCES IN BEHAVIORAL ECONOMICS 162, 171 (Colin F. Camerer et al. eds., 2004).

45. Jonathan Gruber, *The Consumption Smoothing Benefits of Unemployment Insurance*, 87 AM. ECON. REV. 192, 192 (1997); Edi Karni, *Optimal Unemployment Insurance: A Survey*, 66 S. ECON. J. 442, 443, 447 (1999).

46. Karni, *supra* note 45, at 447.

47. CONG. BUDGET OFFICE, *supra* note 7, at 9–10; U.S. GOV'T ACCOUNTABILITY OFFICE, *supra* note 12, at 33 (summarizing findings of econometric studies). For example, Professor Gruber reports that, in the absence of UI, household consumption would on average fall *three times as far* during periods of unemployment. Gruber, *supra* note 45, at 195.

48. Gruber, *supra* note 45, at 192; Karni, *supra* note 45, at 461.

49. Gruber, *supra* note 45, at 192; Karni, *supra* note 45, at 444–45.

50. Martin Feldstein, *Rethinking Social Insurance*, 95 AM. ECON. REV. 1, 2, 4 (2005). Indeed, this close similarity between a tax system and compelled purchase of insurance was the basis on which many commentators and litigants defended the "mandate" provisions of the

Many households also could not replicate the UI lifeline through other forms of saving or borrowing.[51] 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.[52] Others may, for whatever reason, fail to plan adequately.[53] The transaction costs of saving and investing may also be substantial. For example, evidence now shows that many households make very poor decisions in their long-term savings strategies.[54] As we will see shortly, precautionary savings is also a mixed blessing for the economy as a whole. Moreover, many struggling households do not have ready access to affordable credit to substitute for savings.[55] Recent studies confirm these predictions, finding that UI adds significantly to the amount of income-smoothing that private arrangements would permit.[56]

Direct government spending, financed out of general revenues rather than through a dedicated UI tax, could provide yet another potential alternative for out-of-work individuals, but the U.S. has gone in exactly the opposite direction. Most of the major benefits state and federal governments offer to needy households are tied to work.[57] The minimum wage and earned income

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Affordable Care Act. *E.g.*, Brief of Constitutional Law Scholars as Amici Curiae in Support of Petitioners, Dep't of Health and Human Servs. v. Florida, 567 U.S. 904 (2012) (No. 11-398), https://www.americanbar.org/content/dam/aba/publications/supreme_court_preview/briefs/11-398_petitioner_amcu_conlawscholars.authcheckdam.pdf; Brian Galle, *Conditional Taxation and the Constitutionality of Health Care Reform*, 120 YALE L. J. ONLINE 27, 28–36 (2010).

51. Gruber, *supra* note 45, at 192; Nicholson & Needels, *supra* note 1, at 55.

52. Indeed, half of job losers in the U.S. have zero liquid savings at the time of the job loss. Raj Chetty, *Moral Hazard Versus Liquidity and Optimal Unemployment Insurance*, 116 J. POL. ECON. 173, 174 (2008).

53. Feldstein, *supra* note 50, at 4–5.

54. Shlomo Benartzi & Richard H. Thaler, *Heuristics and Biases in Retirement Savings Behavior*, 21 J. ECON. PERSP. 81, 82–84 (2007); Hersh Shefrin, *Behavioralizing Finance*, 4 FOUND. & TRENDS FIN. 1, 25–27 (2009).

55. Sumit Agarwal et al., *The Reaction of Consumer Spending and Debt to Tax Rebates—Evidence from Consumer Credit Data*, 115 J. POL. ECON. 986, 987–89 (2007); David S. Johnson et al., *Household Expenditures and the Income Tax Rebates of 2001*, 96 AM. ECON. REV. 1589, 1589 (2006). *See generally* Stephen P. Zeldes, *Consumption and Liquidity Constraints: An Empirical Investigation*, 97 J. POL. ECON. 305 (1989).

56. *See, e.g.*, Chetty, *supra* note 52, at 174–75; Kory Kroft & Matthew Notowidigdo, *Should Unemployment Insurance Vary with the Unemployment Rate? Theory and Evidence*, 83 REV. ECON. STUD. 1092 (2016).

57. KATHRYN J. EDIN & H. LUKE SHAEFER, $2.00 A DAY: LIVING ON ALMOST NOTHING IN AMERICA, at xxiii, 8–9 (2015).

tax credit boost low-earners' wages.[58] TANF, the modern replacement for the welfare program, includes work requirements in most jurisdictions.[59] Many states are even looking at expanding on Indiana's recent model in which government-funded health insurance for the poor also requires work or a compelling excuse for lack of work.[60] And, aside from the premium support credits of the Affordable Care Act, none of these programs offer much assistance to dual-earner lower middle-income households, who might avoid poverty when one earner loses his or her job, but still suffer considerable financial hardship.[61]

Finally, UI likely strengthens workers' bargaining power with management, and potentially can create a "trust premium" that benefits worker and employer alike. One way that employers can get workers to give in to the employers' demands is to threaten workers with the costs of being fired.[62] If there is a UI safety net for the worker, that threat is less intimidating, allowing her to stick more resolutely to her position.[63] Knowing that employers are less able to exploit their workers also helps to build trust between the two sides, enabling workers to make job-specific investments without fear that their employer will strip away all the value of the investment.[64]

58. Daniel Shaviro, *The Minimum Wage, the Earned Income Tax Credit, and Optimal Subsidy Policy*, 64 U. CHI. L. REV. 405, 411–18, 459–60 (1997).

59. Noah Zatz, *Welfare to What?*, 57 HASTINGS L.J. 1131, 1138–73 (2006).

60. MaryBeth Musumeci, Rachel Garfield & Robin Rudowitz, *Medicaid and Work Requirements: Guidance, State Waiver Details and Key Issues*, HENRY J. KAISER FAM. FOUND. (Jan. 16, 2018), http://www.kff.org/medicaid/issue-brief/medicaid-and-work-requirements/.

61. *See* KAREN NEEDELS, WALTER CORSON & WALTER NICHOLSON, LEFT OUT OF THE BOOM ECONOMY: UI RECIPIENTS IN THE LATE 1990S, at xvii (2001) (reporting that UI program primarily benefits families who are ineligible for other transfer programs); Anne L. Alstott, *The Earned Income Tax Credit and the Limitations of Tax-Based Welfare Reform*, 108 HARV. L. REV. 533, 536 (1995) (noting that most traditional welfare programs quickly phase out for households with labor income); Marianne Bitler, Hilary Hoynes & Elira Kuka, *Do In-Work Tax Credits Serve as a Safety Net?*, J. HUM. RESOURCES 319, 320 (2017).

62. *See* Bertil Holmlund, *Unemployment Insurance in Theory and Practice*, 100 SCANDINAVIAN J. ECON. 113, 120–21 (1998) (modeling impact of workers' outside options on wages).

63. *See id.*

64. *See* Edward L. Glaeser & Andrei Shleifer, *Not-for-Profit Entrepreneurs*, 81 J. PUB. ECON. 99, 108 (2001) (describing mechanisms employers use to induce workers to invest without fear of exploitation).

### *B. For the Economy*

In addition to its important role for families, UI is perhaps the most effective fiscal tool governments can use to combat recession.[65] To simplify a bit, a central problem during many recessions is a downward spiral of demand.[66] When some employees lose their jobs, they stop buying things, reducing the need for workers at other workplaces, who in turn stop buying things, and so on. It would be in the collective interest of each worker and each employer to escape recession. The costs of consumption and hiring are borne by each worker and employer, however, while the benefits of their purchases and hiring decisions flow to many other people. In short, during recessions hiring and consumption create significant economic spillovers or "positive externalities."[67]

Standard modern macroeconomic theory suggests that during recessions government should aim to boost demand by spending money—or, equivalently, by cutting taxes—and in particular by spending in ways that produce the most economic bang for the buck.[68] Dropping money from helicopters might be a useful way to put cash in people's pockets, but that won't much help fight recessions if everyone then buries the money in their back yard. Instead, government wants to put cash in the hands of those with the greatest "marginal propensity to spend," or, more simply, the folks who will buy stuff with their new wealth.[69] If they do so, that can lead to more hiring, resulting in yet more demand, and so on, reversing the downward spiral.[70] Measures of this return on investment are usually called the "multiplier."[71]

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65. U.S. GOV'T ACCOUNTABILITY OFFICE, *supra* note 12, at 40–41, 43–44; LAWRENCE CHIMERINE, THEODORE S. BLACK & LESTER COFFEY, U.S. DEP'T OF LABOR, OCCASIONAL PAPER NO. 99-8, UNEMPLOYMENT INSURANCE AS AN AUTOMATIC STABILIZER: EVIDENCE OF THE EFFECTIVENESS OVER THREE DECADES 5–9, 60–79 (1999), https://oui.doleta.gov/dmstree/op/op99/op_08-99.pdf. Fiscal tools may be especially important in an environment in which the Federal Reserve's monetary policy options are limited by existing, very low, interest rates. FURMAN, *supra* note 15, at 3.

66. U.S. GOV'T ACCOUNTABILITY OFFICE, *supra* note 12, at 40 (noting that UI benefits can provide economic stabilization by increasing aggregate demand during downturn); *see* DAVID ROMER, ADVANCED MACROECONOMICS ch. 11.3 (4th ed. 2012); N. GREGORY MANKIW, MACROECONOMICS ch. 18 (9th ed. 2016).

67. ROMER, *supra* note 66, at ch. 11.3.

68. *Id.*

69. FURMAN, *supra* note 15, at 5.

70. CHIMERINE, BLACK & COFFEY, *supra* note 65, at 12.

71. ROMER, *supra* note 66, at ch. 12.7.

UI has among the largest multipliers of any large-scale government program or tax cut.[72] Households receiving UI will tend to spend, not save, because those households are worse off than they will likely be at other times of their lives.[73] Most estimates find accordingly that government expenditures on UI have multipliers of 1.6 or higher, with some exceeding 2.0.[74] For comparison, corporate tax cuts, such as those enacted by Congress during the 2001 recession, earn multipliers lower than 1.0.[75] 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.[76] There was, though, very significant variation in UI efficacy across states, reflecting the varying local rules for UI administration, as I will detail in a moment.[77]

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, diminishing aggregate demand.[78] This effect has also been observed in other safety-net programs, such as health insurance.[79] Adequate UI programs therefore help to prop up consumer demand when economic dark clouds gather.

Recent research also suggests that UI may contribute to both household well-being and the economy in yet other ways. UI benefits allow workers to

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72. U.S. GOV'T ACCOUNTABILITY OFFICE, *supra* note 12, at 41. *See generally* Alan J. Auerbach & Daniel Feenberg, *The Significance of Federal Taxes as Automatic Stabilizers*, 14 J. ECON. PERSP. 37 (2000).

73. CONG. BUDGET OFFICE, *supra* note 7, at 13.

74. CONG. BUDGET OFFICE, POLICIES FOR INCREASING ECONOMIC GROWTH AND EMPLOYMENT IN 2012 AND 2013, at 28 tbl.1 (2011) (statement of Douglas W. Elmendorf, Director, Congressional Budget Office); WAYNE VROMAN, THE ROLE OF UNEMPLOYMENT INSURANCE AS AN AUTOMATIC STABILIZER DURING A RECESSION 48 (2010).

75. CONG. BUDGET OFFICE, *supra* note 74, at 28 tbl.1.

76. EXEC. OFFICE OF THE PRESIDENT, COUNCIL OF ECON. ADVISORS, THE ECONOMIC IMPACT OF RECENT TEMPORARY INSURANCE EXTENSIONS 5 (2010); VROMAN, *supra* note 74, at 45–49.

77. VROMAN, *supra* note 74, at 49–51. The U.S. UI system has also been less effective in the recent past than systems in other countries. *See generally* Mathias Dolls, Clemens Fuest & Andreas Peichl, *Automatic Stabilizers and Economic Crisis: US vs. Europe*, 96 J. PUB. ECON. 279 (2012).

78. *See* CHIMERINE, BLACK & COFFEY, *supra* note 65, at 12 (noting that UI "mitigates against overcautiousness in spending"). *See generally* Eric M. Engen & Jonathan Gruber, *Unemployment Insurance and Precautionary Saving*, 47 J. MONETARY ECON. 545 (2001).

79. *See generally* Jonathan Gruber & Aaron Yelowitz, *Public Health Insurance and Private Savings*, 107 J. POL. ECON. 1249 (1999).

spend longer searching for jobs that are the best match for their skills.[80] Similarly, the possibility of a safety net may allow workers to take greater risks, allowing for greater innovation, "intrapreneurship," (that is, invention within an existing employment relationship), and economic growth.[81] UI systems may help workers maintain an attachment to the workforce and aid them in finding retraining and new job opportunities.[82] And, finally, some unpublished work suggests UI helps to boost credit and credit repayment, which can have important positive spillovers during recessions, like the most recent, in which mortgage defaults are a major driver of economic turmoil.[83]

## II. THE GREAT RECESSION AND THE FAILURE OF THE UI SYSTEM

The Great Recession exposed in dramatic fashion important structural weaknesses in the design of the American UI system. Even as the availability of UI helped to prop up the economy during the recent recession and to shield individual families from the hardships the recession brought, key aspects of the program were also hurting the economy, and leaving without any benefits households that had long been effectively contributing UI premiums. UI betrayed its promises. I will first explore, in this Part, UI's failings, and then in Part III examine the factors that lead here.

UI failed in two distinct ways. One failure, relatively well-known to the handful of scholars who closely study social insurance programs, was in the remarkably small share of unemployed households who actually received benefits. A second, less familiar, story is that the system for paying for UI financing had unexpectedly perverse effects on the labor market. In effect, while states and the federal government were struggling to incentivize employers to hire more, the UI system was imposing an extra tax burden on each new job.

80. Chetty, *supra* note 52, at 174; Arash Nekoei & Andrea Weber, *Does Extending Unemployment Benefits Improve Job Quality?*, 107 AM. ECON. REV. 527, 527–28 (2017).

81. *See* Daron Acemoglu & Robert Shimer, *Productivity Gains from Unemployment Insurance*, 44 EUR. ECON. REV. 1195, 1195–96 (2000); *see also* Darian M. Ibrahim, *Intrapreneurship*, 73 WASH. & LEE L. REV. 1741, 1750–51 (2016) ("The basic difference between intrapreneurship and entrepreneurship is that intrapreneurship is innovative activity that happens within a large, established firm, whereas entrepreneurship is innovative activity that is pursued through a new firm (a startup) established primarily for that purpose." (footnote omitted)).

82. CHIMERINE, BLACK & COFFEY, *supra* note 65, at 42; FURMAN, *supra* note 15, at 3, 6.

83. *See generally* Joanne W. Hsu, David A. Matsa & Brian T. Melzer, *Positive Externalities of Social Insurance: Unemployment Insurance and Consumer Credit* (Nat'l Bureau of Econ. Research, Working Paper No. 20353, 2014), http://www.nber.org/papers/w20353.pdf.

### *A. The Collapse in Available Benefits*

The benefits story, as I've said, is documented elsewhere, so my coverage will be relatively brief.[84] Most glaringly, fewer than one in three workers who lost their jobs over the last decade received UI benefits, a massive drop from a peak of more than 45% during the middle of the last century.[85] The decline is even more marked in Southern states, where in some places fewer than one in six separated workers receive benefits.[86]

This low benefit rate was the product of a combination of smaller failures. Most states effectively prevent part-time and seasonal workers from claiming UI benefits,[87] and a much greater share of modern workers rely on one or more part-time jobs than was true in the past (among other reasons, because many more women are working).[88] Similarly, UI does not typically cover independent contractors, a status that is far more common today, in part as a way of avoiding UI tax burdens.[89] States have generally gotten stricter over time in their rules for when workers who left without being fired can claim benefits.[90]

The share of eligible workers who actually receive benefits has fallen over time as well. Aided by expert consultants, employers manage worker tasks and hours to minimize the number who will claim UI benefits, and outsource some tasks to states where UI eligibility rules are tighter.[91] Large-scale surveys and other data show that at least 10% of workers incorrectly believe they are ineligible for benefits.[92] Traditionally, labor unions were essential in

84. ACUC, *supra* note 6, at 2; Nicholson & Needels, *supra* note 1, at 50–51.

85. *See* sources cited *supra* note 13.

86. STETTNER, *supra* note 2, at 11.

87. Lester, *supra* note 5, at 346, 355; *see* National Employment Law Center, Unemployment Insurance Policy Advocate's Toolkit, at 14, https://www.nelp.org/wp-content/uploads/1D-Expanding-Part-Time-Eligibility-UI-Toolkit.pdf (last visited Jan. 17, 2019) (stating that as of 2015, part-time workers could in practice obtain benefits in only 10 states).

88. SAUL J. BLAUSTEIN ET AL., UNEMPLOYMENT INSURANCE IN THE UNITED STATES: THE FIRST HALF CENTURY 8–9 (1993); CHAD STONE & WILLIAM CHEN, CTR. ON BUDGET & POLICY PRIORITIES, INTRODUCTION TO UNEMPLOYMENT INSURANCE 3 (2014); Jerry L. Mashaw, *Unemployment Compensation: Continuity, Change, and the Prospects for Reform*, 29 U. MICH. J.L. REFORM 1, 5–7 (1995); Nicholson & Needels, *supra* note 1, at 53, 61.

89. ACUC, *supra* note 6, at 15–16; FURMAN, *supra* note 15, at 4–5.

90. Bassi & McMurrer, *supra* note 13, at 70–71. For a summary just of recent cut-backs in eligibility rules, see STETTNER, *supra* note 2, at 9–11.

91. U.S. GEN. ACCOUNTING OFFICE, *supra* note 6, at 38–40.

92. *See* Wayne Vroman, *Unemployment Insurance Recipients and Nonrecipients in the CPS*, 132 MONTHLY LAB. REV. 44, 49–50 (2009); Stephen A. Wandner & Andrew Stettner, *Why Are Many Jobless Workers Not Applying for Benefits?*, 123 MONTHLY LAB. REV. 21, 28–30 (2000); *see also* ACUC, *supra* note 6, at 21 (noting that because many details of UI eligibility are

guiding workers through the unemployment benefits maze, and the decline of labor may well explain workers' rising inability to navigate it.[93] And many workers who expect (not always rightly) to return to work quickly also fail to apply for benefits, suggesting that inertia and "hassle costs" form barriers to eligibility.[94]

Each dollar of benefit now provides less net benefit to recipients than during the first half of UI history. Since the early 1980s, UI benefits are federally taxable.[95] Depending on their exact tax rate, beneficiaries take home around 80 to 85% of the benefits they earn.[96] This loss in value may have reduced workers' incentive to seek benefits at all.[97] Further, because state UI offices typically withhold federal taxes due from UI benefit checks,[98] these dollars reduce the household's earning power in real time, rather than (say) being deferred until the beneficiary files a tax return in the following year.

Even workers who initially receive benefits often lose them before finding another job, and this phenomenon has worsened over time.[99] States can determine the duration of benefits.[100] Changes to state systems were curtailing workers' benefit duration as early as the 1990s.[101] Several states have further shortened their benefit duration from twenty-six to twenty weeks in recent years.[102] These developments are occurring even as underlying structural changes in the economy, such as the shift from manufacturing to service industries, leave workers without skills for the new jobs obliged to search

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determined through caselaw, workers are easily confused about whether they meet eligibility requirements).

These mistaken understandings are unlikely to be wholly accidental. As David Super has observed, the use of informal "hassle" and shaming techniques to reduce benefit uptake has become increasingly common among other benefit programs. David A. Super, *Offering an Invisible Hand: The Rise of the Personal Choice Model for Rationing Public Benefits*, 113 YALE L.J. 815, 818–20, 844–50 (2004). As Super also notes, though, these barriers can also arise through inertia and the indifference of policy makers to the burdens struggling households face. *Id.* at 850.

93. Lester, *supra* note 5, at 358.

94. *See* Vroman, *supra* note 92, at 49–50.

95. Bassi & McMurrer, *supra* note 13, at 69.

96. *See* 26 U.S.C § 1 (2018) (setting out individual income tax rates); Cong. Budget Office, *supra* note 1, at 4 ("[T]he typical UI recipient has fallen into the 15 percent tax bracket . . . .").

97. Nicholson & Needels, *supra* note 1, at 61.

98. *See* U.S. DEP'T OF LABOR, *supra* note 1, at 4.

99. Nicholson & Needels, *supra* note 1, at 48, 55.

100. U.S. DEP'T OF LABOR, *supra* note 1, at 11.

101. NEEDELS, CORSON & NICHOLSON, *supra* note 61, at xiv–xv.

102. KATELIN P. ISAACS, CONG. RESEARCH SERV., R41859, UNEMPLOYMENT INSURANCE: CONSEQUENCES OF CHANGES IN STATE UNEMPLOYMENT COMPENSATION LAW 7–8 (2018), https://fas.org/sgp/crs/misc/R41859.pdf.

long periods for replacement employment.[103] Occupational licensing and restrictive zoning in job-rich areas further contribute to long "lock-out" periods for those who want to change career paths.[104] Fueled by a rise in the UI consulting industry, employers have grown considerably more skilled and aggressive than in the past, resulting in more workers being found ineligible or cut off from benefits before those benefits expire.[105]

It might be argued that these outcomes were not failures, but appropriate results of a UI system that has been optimized to prevent moral hazard. That is, a common worry with UI, as with other social insurance programs, is that offering workers benefits when their income is low will discourage them from working.[106] In the case of UI specifically, the concern is mostly that once unemployed, workers will not expend as much effort to find a new job, doing only the minimum search needed to satisfy eligibility limits, although other unwanted behavioral responses are also possible.[107] To balance against this unwanted side-effect, economists suggest that an optimal "replacement rate" for lost wages would pay workers only a fraction of their lost wage, in expectation, or would pay for only a limited duration, or both, so that workers retain an incentive to reenter the workforce.[108]

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103. *See* ACUC, *supra* note 6, at 1; NEEDELS, CORSON & NICHOLSON, *supra* note 61, at xviii.

104. David Schleicher, *Stuck! The Law and Economics of Residential Stagnation*, 127 YALE L.J. 78, 114–122 (2017).

105. *E.g.*, *Reducing Unemployment Insurance Costs / UI and SUTA State Unemployment Taxes*, STAFFMARKET, https://www.staffmarket.com/reduce-unemployment-insurance-ui-suta-costs (last visited Dec. 24, 2018) ("To keep your rate from being adversely affected you must contest all questionable unemployment benefit claims made against your company."); ADP, ADP UNEMPLOYMENT COMPENSATION MANAGEMENT SERVICES 2 (2011), https://www.adp.com/~/media/PDF/ADP%20UCM%20Services%20Overview.ashx ("Effective claims administration is the best way to reduce UI benefit charges and minimize your SUI costs. . . . ADP will formulate a response (protest) to the state agency with all pertinent information within the statutory timeframe."); *see also* Nicholson & Needels, *supra* note 1, at 61–62 (mentioning possibility that employer efforts to prevent claims have grown more aggressive as one explanation for decline in benefits).

106. Karni, *supra* note 45, at 444; Nicholson & Needels, *supra* note 1, at 55. For a slightly dated but still useful overview of the evidence of the effect of UI on labor supply, see Alan B. Krueger & Bruce D. Meyer, *Labor Supply Effects of Social Insurance*, *in* 4 HANDBOOK OF PUBLIC ECONOMICS 2327 (Alan J. Auerbach & Martin Feldstein eds., 2002).

107. Feldstein, *supra* note 50, at 10; Nicholson & Needels, *supra* note 1, at 56.

108. Nicholson & Needels, *supra* note 1, at 55, 57. Alternative incentive structures, such as allowing benefits to decline over time, may be more effective substitutes for a simple program of partial replacement. Karni, *supra* note 45, at 450–52; Nicholson & Needels, *supra* note 1, at 56. Recent theory and empirical results have complicated that story and have shown that benefit duration may be more important than the replacement rate. Konstantinos Tatsiramos & Jan C. van Ours, *Labor Market Effect of Unemployment Insurance Design*, 28 J. ECON. SURVEYS 284, 301–02 (2014). These issues are important to the ultimate success of a UI system, but peripheral to the financing questions that are my focus here.

Few of the UI failings I've described would fit this optimal design structure. There is no obvious reason, for instance, why the replacement rate for part-time workers should be zero.[109] It might be argued that worker confusion and hassle serve as screening devices, in the sense that workers who fail to claim benefits to which they're entitled didn't "need" the benefits in some sense.[110] In fact, the opposite is likely to be true; less sophisticated and more impatient workers on average have lower lifetime earnings.[111] Moreover, the positive spillover from UI benefits, both for the economy and the workers' families, is unlikely to differ depending on whether the worker is informed about UI procedures or patient enough to wade through them.

Rules pertaining to benefits duration, and to eligibility after "voluntary" separations, do reflect competing concerns, but there is little reason to think states have struck the right balance. Benefit limits help to mitigate potential moral hazard.[112] Again, however, both sets of limits have gotten notably stricter over the past two decades. There is no empirical evidence to suggest that the limits in place for the first seventy years of the UI program, before recent tightening, resulted in UI benefits that were more generous than optimal.[113] Indeed, Raj Chetty has presented evidence that optimal replacement rates should be higher than the historic average.[114] Other recent

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109. To the extent that part-time workers are less "attached" to the workforce than others—that is, that they value their non-work time more highly—it might make sense to offer them a lower replacement rate. *See* Nicholson & Needels, *supra* note 1, at 60 (discussing impact of worker heterogeneity on optimal design). Assume workers will work when the value of non-work plus unemployment benefits is less than the wage. If we want everyone to go back to work, we should offer a lower unemployment benefit to those who value non-work more highly. But it is very unlikely this lower rate would be zero. Further, the premise that everyone should go back to work assumes that the "non-work" activity itself lacks social value, such as might be created by volunteering or child care.

110. Albert L. Nichols & Richard J. Zeckhauser, *Targeting Transfers Through Restrictions on Recipients*, 72 AM. ECON. REV. 372, 376–77 (1982).

111. Brian C. Cadena & Benjamin J. Keys, *Human Capital and the Lifetime Costs of Impatience*, 7 AM. ECON. J. 126, 126–50 (2015); Bart H.H. Golsteyn, Hans Grönqvist & Lena Lindahl, *Adolescent Time Preferences Predict Lifetime Outcomes*, 124 ECON. J. F739 *passim* (2014); *see also* Super, *supra* note 92, at 853–54 (noting that ordeal mechanisms are inefficient to the extent that neediest potential beneficiaries are often least able to navigate bureaucratic systems).

112. Nicholson & Needels, *supra* note 1, at 56–57.

113. *See* FURMAN, *supra* note 15, at 6–8 (arguing that most measures of moral hazard are overstated); Nicholson & Needels, *supra* note 1, at 67 (stating that the "empirical foundation" for changes to UI is "weak").

114. Chetty, *supra* note 52, at 176; *see also* Jesse Rothstein, *Unemployment Insurance and Job Search in the Great Recession*, BROOKINGS PAPERS ON ECON. ACTIVITY, Fall 2011, at 143, 181 (finding that much of the effect of UI on unemployment is through incentives for workers to stay in the workforce rather than retire).

research suggests moral hazard is lower during recessions.[115] Since this is also the period in which positive externalities are higher, it is likely that state policies that are suitable for ordinary times are overly harsh during downturns.[116]

### *B. The Tax on Jobs*

UI was not only far less generous during the Great Recession than it had been in Twentieth Century downturns, but it also proved to affirmatively discourage new hiring. Through a combination of well-intentioned features of the system for financing UI payments, both states and the federal government ended up in effect imposing new taxes on each new hire or rehire. These extra burdens, at the margin, may have contributed to the long and painful recovery period many states experienced after 2008.

To understand how this came about, we need a bit more detail on how UI benefits are funded. Federal law requires—or, more precisely, very strongly incentivizes—states to finance UI benefits through a tax on state employers.[117] For each employee, the state employer pays an annual percentage of the employee's salary, up to the "wage base" amount.[118] In many states, this base is very low, averaging around $9,000, but ranging as high as $45,000, so that most of each employee's salary is untaxed.[119] The percentage varies by employer, depending on how often the employer's workers successfully claim UI benefits.[120] Average taxes are just under $500 per employee.[121] Since claims paid out are likely to exceed taxes paid in during recessions, states are expected to keep a "Trust Fund" account in

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115. Johannes F. Schmieder et al., *The Effects of Extended Unemployment Insurance Over the Business Cycle: Evidence from Regression Discontinuity Estimates Over 20 Years*, 127 Q.J. ECON. 701, 703, 746–47 (2012).

116. Kory Kroft & Matthew J. Notowidigdo, *Should Unemployment Insurance Vary with the Unemployment Rate? Theory and Evidence*, 83 REV. ECON. STUD. 1092, 1093 (2016); Tatsiramos & van Ours, *supra* note 108, at 307; *cf.* Krueger & Meyer, *supra* note 106, at 2385–86 (observing that this is a theoretical possibility without, at the time, any empirical support).

117. *See* U.S. GOV'T ACCOUNTABILITY OFFICE, *supra* note 12, at 17, 23. States that fail to adhere to the statutory financing structure subject their in-state employers to a very large federal penalty tax. No state has ever triggered this tax.

118. U.S. DEP'T OF LABOR, *supra* note 1, at 10–11.

119. *See* U.S. DEP'T OF LABOR, SIGNIFICANT PROVISIONS OF STATE UNEMPLOYMENT INSURANCE LAWS EFFECTIVE JANUARY 2017, https://workforcesecurity.doleta.gov/unemploy/content/sigpros/2010-2019/January2017.pdf.

120. *Id.*

121. STONE & CHEN, *supra* note 88, at 8.

which they accumulate excess payments for use during future revenue shortfalls.[122]

Several mechanisms help to ensure that money will keep flowing even if state savings turn out to be inadequate to cover benefit demand. First, U.S. DOL regulations require states to automatically increase UI tax rates when their Trust Fund accounts approach empty.[123] Between 2009 and 2011, a handful of states disregarded this rule and repealed their automatic increase, with no apparent adverse reaction from DOL, but taxes went up in a number of other jurisdictions.[124] About half the states have other forms of automatic tax increases when trust fund balances decline.[125] Similarly, experience-rated taxes, by definition, rise as employers lay off more workers.[126]

In addition, states that deplete their available UI funds can borrow from the federal UI trust fund.[127] Federal trust fund dollars are collected through a very low-rate tax imposed on the first $7,000 of each employer's wages paid to each worker.[128] 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 $21 (.03% of the wage base) per employee per year in federal UI taxes.[129] There are yet larger penalties for

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122. ACUC, *supra* note 6, at 10–11.

123. LEACHMAN ET AL., *supra* note 2, at 1.

124. WAYNE VROMAN, URBAN INST., UNEMPLOYMENT AND RECOVERY PROJECT, UNEMPLOYMENT INSURANCE AND THE GREAT RECESSION 4 (2011), https://www.urban.org/sites/default/files/publication/26766/412462-Unemployment-Insurance-and-the-Great-Recession.PDF.

125. U.S. DEP'T OF LABOR, *supra* note 119; Wayne Vroman & Stephen A. Woodbury, *Financing Unemployment Insurance*, 67 NAT'L TAX J. 253, 256–58 (2014); *see Improving Efforts to Help Unemployed Americans Find Jobs: Hearing Before the Comm. on Ways and Means*, 112th Cong. 40 (2011) (statement of Douglas J. Holmes, President, UWC-Strategic Services on Unemployment and Workers' Compensation) (claiming that average state UI taxes rose by 34% during 2009 and 2010).

126. NAT'L EMP'T LAW CTR., UNEMPLOYMENT INSURANCE FINANCING IN CRISIS: HOW SHOULD STATES RESPOND TO TRUST FUND INSOLVENCY? 3 (2010), https://www.nelp.org/wp-content/uploads/2015/03/StateSolvencyStrategies.pdf.

127. U.S. GOV'T ACCOUNTABILITY OFFICE, *supra* note 12, at 12.

128. *Id.* at 11.

129. *Id.* at 12, 13 n.26. Congress suspended these provisions for 2009 and 2010. American Recovery and Reinvestment Act of 2009, Pub. L. No. 111-5, 123 Stat. 115 (2009).

States are eligible for interest-free borrowing if they hit three incentive targets. First, the state must have, within five years of the borrowing date, held enough in their trust fund to pay 80% of the expected recession-period cost of benefits. Second, for each year since the trust-fund target was last met, the average tax rate on state employers must have been at least 75% of the average cost of benefits over the prior five-year period. And, lastly, the average tax rate for each year of that period can have been no lower than 80% of the prior year's tax rate. Many states have not been close to these incentives for many years. *E.g.*, DIV. OF FISCAL & ACTUARIAL SERVS., debts that take three or more years to repay, but few states have ever triggered these.[130] State interest payments are due quickly and cannot be paid out of state UI taxes, and so threaten some significant general budget pain for states that rely heavily on the federal Trust Fund.[131]

States borrowed massively during the Great Recession.[132] Thirty-six states ran out of funding in their individual trust funds, and collectively went more than $50 billion in debt to the federal government.[133] The federal trust fund, too, was exhausted, and was obliged to borrow from general Treasury revenues.[134] Several states turned to private creditors in hopes of avoiding federal interest and penalties, racking up a few extra billion in bond debt.[135] These debts hung over states for years, with a number triggering unpaid interest penalties.[136]

In sum, even as states were in the throes of, or still recovering from, their economic struggles, the UI system was forcing them to raise taxes. Worse, those new taxes were determined by how many workers the state's businesses employed. UI financing, in other words, was discouraging hiring at exactly the time we most wanted to encourage it. 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 almost inevitably follow.[137] 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.

Many of these automatic taxes and penalties could have been avoided if state trust fund balances had been ample enough to cover benefits paid. The trouble, of course, is that trust funds were woefully short of this level. While UI experts were aware for some time that trust fund balances were low, and

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U.S. DEP'T OF LABOR, STATE UNEMPLOYMENT INSURANCE TRUST FUND SOLVENCY REPORT 2017, at 60 tbl.2 (2017).

130. U.S. GOV'T ACCOUNTABILITY OFFICE, *supra* note 12, at 61 tbl.3 (showing that California may be an exception).

131. *See* U.S. DEP'T OF LABOR, *supra* note 1, at 8–9.

132. DIV. OF FISCAL & ACTUARIAL SERVS., U.S. DEP'T OF LABOR, STATE UNEMPLOYMENT INSURANCE TRUST FUND SOLVENCY REPORT 2014, at 3, 5 (2014).

133. *Id.*

134. Vroman & Woodbury, *supra* note 125, at 253.

135. *Id.* at 258.

136. CONG. BUDGET OFFICE, *supra* note 7, at 8.

137. ACUC, *supra* note 6, at 6; LEACHMAN ET AL., *supra* note 2, at 2.

getting steadily lower over the years, the extent of the shortfall and the length of the recession nonetheless were unexpected.[138]

## III. WHY UI FAILED

In some senses the explanation for how UI has come to this pass is depressingly familiar. UI's structural problems closely resemble the institutional and political problems that have bedeviled U.S. infrastructure spending, as well as those that discourage state and local governments from establishing "rainy day funds" or adequately contributing to their employee pension funds.[139] A few unique features of UI further contribute to its malaise.

Federalism is the root of most of UI's failings. The decision to finance and administer UI mostly at the state level was based in politics, not policy. As other commentators recognize, modern theories of fiscal federalism predict that states will systematically underinvest in UI, and there is direct historical evidence to support those predictions.[140]

Briefly, the problem is a mismatch of taxes and benefits. UI's benefits spill over across borders.[141] Because state economies are so intertwined, many of the macroeconomic returns of UI expenditures accrue outside of the state paying the benefits.[142] For example, when the unemployed have more money in their pocket, they may buy goods from neighboring states, rather than their own. Families may also relocate while collecting UI benefits.

At the same time, the legal incidence of UI taxes falls on businesses, many of which could readily relocate their operations or reallocate some workers to a jurisdiction with lower rates. Evidence suggests that businesses ultimately pay these taxes by reducing worker salaries, but it is precisely the employer's greater ability to threaten to relocate that allows it to do so.[143]

138. CONG. BUDGET OFFICE, *supra* note 7, at 17 (noting that "fairly rapid recoveries" after prior recessions caused few issues).

139. *See* Galle & Stark, *supra* note 8, at 615 (comparing rainy day funds to UI Trust Funds).

140. ACUC, *supra* note 6, at 27–28; Mashaw, *supra* note 88, at 3–4.

141. *See* ACUC, *supra* note 6, at 10–11.

142. ACUC, *supra* note 6, at 10, 28, 37; Robert P. Inman, *Transfers and Bailouts: Enforcing Local Fiscal Discipline with Lessons from U.S. Federalism*, *in* FISCAL DECENTRALIZATION AND THE CHALLENGE OF HARD BUDGET CONSTRAINTS 35, 45–47 (Jonathan Rodden, Gunnar S. Eskeland & Jennie Litvack eds., 2003); Robert P. Inman & Daniel L. Rubinfeld, *Can We Decentralize Our Unemployment Policies? Evidence from the United States*, 54 KYKLOS 287, 301 (2001).

143. *See* Patricia M. Anderson & Bruce D. Meyer, *The Effects of the Unemployment Insurance Payroll Tax on Wages, Employment, Claims and Denials*, 78 J. PUB. ECON. 81, 87 (2000). Employers can claim a federal deduction for their state UI taxes, however. I.R.C. § 164

Long-run incidence also does not help businesses who must bear brief spikes in tax rates to fill in empty trust funds during recessions.[144] Each business captures only a small fraction of the improved economic conditions that result from UI spending, and few employers likely appreciate the added bargaining power it affords workers. And from a public choice theory perspective, business owners are a more concentrated and homogenous lobbying force than the working public.[145] In short, many businesses have strong incentives and powerful opportunity to resist UI taxation.

The result is a race to the bottom.[146] States that aim to offer generous UI benefits must fund them, and risk driving out employers, triggering unemployment, which must be funded through higher taxes on the remaining businesses. As the U.S. Supreme Court noted when it considered the constitutionality of the UI system, this is precisely what happened in the 1930s when states attempted to establish their own UI regimes.[147] Even in the absence of actual exit by businesses, the shadow of exit creates unrelenting political pressure to hold taxes low.[148]

Competitive pressures may affect benefits and benefit determinations as well as tax rates. As the Government Accountability Office found, states with lower taxes and trust fund balances were those most likely to pare back benefits.[149] Wayne Vroman finds that state seem to compete not only over the amount or duration of benefits, but also over the rate at which workers are able to qualify.[150] 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.[151]

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(2018); DEP'T OF THE TREASURY, INTERNAL REVENUE SERV., PUB. NO. 535, Business Expenses for Use in Preparing 2017 Returns 18 (2018).

144. LEACHMAN ET AL., *supra* note 2, at 5.

145. *See* Clayton P. Gillette, *Can Public Debt Enhance Democracy?*, 50 WM. & MARY L. REV. 937, 955 (2008) (making this point about state budgets generally).

146. ACUC, *supra* note 6, at 28; Bassi & McMurrer, *supra* note 13, at 82–83.

147. Steward Mach. Co. v. Davis, 301 U.S. 548, 586–88 (1937).

148. Bassi & McMurrer, *supra* note 13, at 82; *see* William W. Bratton & Joseph A. McCahery, *The New Economics of Jurisdictional Competition: Devolutionary Federalism in a Second-Best World*, 86 GEO. L.J. 201, 264–65 (1997) (making this point about state fiscal competition generally); Gillette, *supra* note 145, at 966 (same).

149. U.S. GOV'T ACCOUNTABILITY OFFICE, *supra* note 12, at 15–18; *see also* Daniel L. Smith & Jeffrey B. Wenger, *State Unemployment Insurance Trust Solvency and Benefit Generosity*, 32 J. POL'Y ANALYSIS & MGMT. 536, 536–37 (2013) (reporting that lower trust funds are correlated with benefit reductions).

150. WAYNE VROMAN, URBAN INST., LOW BENEFIT RECIPIENCY IN STATE UNEMPLOYMENT INSURANCE PROGRAMS 157–60 (2001).

151. *Id.* at 159.

The combination of mobile employers and experience rating puts pressure on these systems. Again, because of experience rating, each employer's tax rate goes up whenever a separated employee is awarded benefits.[152] Businesses therefore have strong incentives not only to exert political influence on the benefits determining agencies, but also to invest in lawyering and innovations in business processes that make benefits awards less likely.[153]

Federal efforts to shore up inadequate state financing appear to have compounded the problem of state under-investment.[154] Once more, states with insufficient balances in their own Trust Fund accounts can borrow against the national Fund, in effect providing a guaranteed bailout for bankrupt trust fund accounts. The resulting moral hazard encourages states to underfund their own accounts.

The UI system's penalties on excessive state borrowing have been ineffective at curbing this moral hazard problem. A clever, albeit accidental, feature of the penalty system is that it is imposed directly on employers.[155] Since state legislators share the state budget with other legislators, individual lawmakers would likely not fully internalize penalties imposed on the state itself.[156] In contrast, legislators may view an end to corporate pain as their own private good, since the lawmaker can directly benefit from lobbying efforts by the affected firms.[157]

What is less clever is the failure to index the penalty for inflation. The federal penalty for default has not changed since 1983, and, of course, the

152. *See* sources cited *supra* note 32.

153. *See* Vroman & Woodbury, *supra* note 125, at 265; *see* Julia Fath & Clemens Fuest, *Temporary Layoffs and Unemployment Insurance: Is Experience Rating Desirable?*, 6 GER. ECON. REV. 471, 471 (2005) (noting that many European countries avoid experience rating in order to avoid employer incentives to contest worker benefits); *cf.* ACUC, *supra* note 6, at 39 (noting that employers "make excessive use of appeals system" in response to experience rated taxes).

154. ACUC, *supra* note 6, at 12; Galle & Stark, *supra* note 8, at 616–17.

155. In all likelihood this design choice was the product of legal rules, not political-theory insights. In the 1930s it was unclear if the federal government could constitutionally enact a tax or other financial incentive whose legal incidence fell on states; imposing taxes on employers was seen as more likely to be sustained by the Supreme Court. Katherine Baicker et al., *A Distinctive System: Origins and Impact of U.S. Unemployment Compensation*, *in* THE DEFINING MOMENT: THE GREAT DEPRESSION AND THE AMERICAN ECONOMY IN THE TWENTIETH CENTURY 227, 240–41 (Michael D. Bordo, Claudia Goldin & Eugene N. White eds., 1998).

156. *See* Daryl J. Levinson, *Making Government Pay: Markets, Politics, and the Allocation of Constitutional Costs*, 67 U. CHI. L. REV. 345, 375 (2000); Barry R. Weingast et al., *The Political Economy of Benefits and Costs: A Neoclassical Approach to Distributive Politics*, 89 J. POL. ECON. 642, 656 (1981).

157. *See* Levinson, *supra* note 156, at 375.

real value of $21 has declined significantly since then.[158] As we've seen, during that period, states have greatly reduced their own savings, with many states explicitly shifting 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.[159] In effect, states are planning to borrow against the federal fund and deferring to the future the costs of repaying the resulting loans. Thus, as Kirk Stark and I have argued, 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.[160]

A second critical issue for UI, which also affects the usefulness of the current penalty structure, is time. Very simply, putting money in a trust fund is costly now, while the rewards of paying out benefits generally do not arise until the next deep recession. Due to the time value of money, legislators will discount the usefulness of future payoffs.[161] But the time value of money by itself probably should not have much effect on trust fund savings, because money deposited in trust funds is in fact invested and earning interest, presumably at exactly the discount rate.[162]

Much more important, though, is potentially myopic, or short-sighted, behavior. If state officials behave myopically and assign greater value to immediate pain or rewards than to future incentives 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. Anyone who has driven recently across a U.S. bridge, or enjoyed its fine system of vintage 1970s air-traffic control, can appreciate American underinvestment in long-term infrastructure.[163] 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

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158. LEACHMAN ET AL., *supra* note 2, at 4, 12.

159. *Id.* at 8.

160. Galle & Stark, *supra* note 8, at 616–17. Another data point perhaps supporting this theory is the fact that large states generally have had the smallest tax bases and poorest Trust Fund balances. Vroman, *supra* note 14, at 5 fig.2. That coincidence of facts suggests that large states may view themselves as in essence too big to fail.

161. David Weisbach & Cass R. Sunstein, *Climate Change and Discounting the Future: A Guide for the Perplexed*, 27 YALE L. & POL'Y REV. 433, 439 (2009).

162. *Id.*

163. ROSABETH MOSS KANTER, MOVE: PUTTING AMERICA'S INFRASTRUCTURE BACK IN THE LEAD 221–57 (2015); Panicos O. Demetriades & Theofanis P. Mamuneas, *Intertemporal Output and Employment Effects of Public Infrastructure Capital: Evidence from 12 OECD Economies*, 110 ECON. J. 687, 687 (2000).

governments to deal with the business cycle.[164] States underfund public employee pension funds, and charge inadequate premia to cover likely claims in most of their public disaster-insurance programs.[165] 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.[166]

Political explanations for myopia are fairly straightforward. Officials know that they have a limited time in office.[167] 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.[168] 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.[169] Thus, federalism may be a contributor to myopic behavior, as well as its own independent source of underfunding.

Myopia can also be a psychological phenomenon. Impatience has been widely documented in household finance decisions, and even in decisions by firm managers.[170] If both voters and officials are impatient, then there are few

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164. David Gamage, *Preventing State Budget Crises: Managing the Fiscal Volatility Problem*, 98 CALIF. L. REV. 749, 766–67 (2010); Russell S. Sobel & Randall G. Holcombe, *The Impact of State Rainy Day Funds in Easing State Fiscal Crises During the 1990–1991 Recession*, 16 PUB. BUDGETING & FIN. 28, 33 (1996).

165. Barbara A. Chaney et al., *The Effect of Fiscal Stress and Balanced Budget Requirements on the Funding and Measurement of State Pension Obligations*, 21 J. ACCT. & PUB. POL'Y 287, 292–93 (2002); J. David Cummins, *Should the Government Provide Insurance for Catastrophes?*, 88 FED. RES. BANK ST. LOUIS REV. 337, 358–60 (2006); Amy B. Monahan, *State Fiscal Constitutions and the Law and Politics of Public Pensions*, 2015 U. ILL. L. REV. 117, 123.

166. *See* Howard Kunreuther & Mark Pauly, *Rules Rather than Discretion: Lessons from Hurricane Katrina*, 33 J. RISK & UNCERTAINTY 101, 102–03, 106 (2006) (arguing that neither homeowners nor public sector agencies consider the full range of the consequences of a disaster).

167. Monahan, *supra* note 165, at 128–29; David A. Super, *Rethinking Fiscal Federalism*, 118 HARV. L. REV. 2544, 2639–40 (2005); Gary A. Wagner, *Political Control and Public Sector Savings: Evidence from the States*, 109 PUB. CHOICE 149, 150 (2001).

168. Galle & Stark, *supra* note 8, at 612–13; *see also* Kunreuther & Pauly, *supra* note 166, at 108–09 (arguing that myopic voters will not vote for policies that help to protect against myopia).

169. Arik Levinson, *Balanced Budgets and Business Cycles: Evidence from the States*, 51 NAT'L TAX J. 715, 716 (1998). Thus, residents with other large sunk investments, such as homeowners, may be relatively more attentive to long-term interests than average.

170. See Frederick et al., *supra* note 44, at 172–78, 201–07, for a review. For discussion of the evidence in the context of insuring for future financial disasters, see Kunreuther & Pauly, *supra* note 166, at 106–08.

obvious market-clearing mechanisms by which present-biased officials would be driven from office.[171]

Together, federalism and myopia help to explain many of the UI outcomes we've seen.[172] States keep trust funds low because they do not value the ability to pay benefits in the future. Based on myopia alone, a preference for low trust funds could drive either low taxes or very generous current benefits. Federalism, however, encourages states to strongly prefer low tax rates over high payouts, since there is far more economic and political pressure from mobile and well-organized businesses than from the scattered, relatively immobile, population of individual workers.[173]

To the extent that federal penalty provisions have had any impact, they appear to have further pushed states to squeeze benefits.[174] Again, federal incentives for trust fund solvency could be satisfied either with higher taxes or benefit cutbacks. Many states have pursued both, and some benefit cuts alone, but none have only raised taxes.[175] Further, as penalty provisions have lapsed, states have rescinded their tax increases, but left in place provisions that tend to limit the availability of benefits.[176] 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 1980s.[177]

One last federal factor that might play some role is the federal taxation of UI benefits. Once again, prior to the early 1980s, UI benefits were tax-free to the beneficiary. Now, however, when a state raises a dollar in tax revenue for its trust fund, it can deliver only $1 - t$ (the beneficiary's federal marginal rate) dollars in benefits. In effect the federal government is taxing state savings. Of course, taxing something is usually an excellent way to *discourage* its production, and it is hard to understand why that would be a desirable

171. 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.

172. The combined role of federalism and myopia helps to explain why the UI system has failed while another seemingly similar system, workers' compensation, has not. *See* Baicker et al., *supra* note 155, at 227, 235 n.18 (questioning why there should be a race to the bottom for UI and not workers' compensation). Although worker's compensation is also funded at the state level, it is not subject to the huge recession-driven swings in demand for benefits, and so does not require nearly the degree of savings for the future.

173. Galle & Stark, *supra* note 8, at 612–15.

174. Bassi & McMurrer, *supra* note 13, at 69.

175. U.S. GOV'T ACCOUNTABILITY OFFICE, *supra* note 12, at 19–24; LEACHMAN ET AL., *supra* note 2, at 11.

176. *See* U.S. GEN. ACCOUNTING OFFICE, *supra* note 6, at 4–5.

177. ACUC, *supra* note 6, at 2, 6.

outcome here.[178] Taxing benefits encourages states that seek to balance their trust funds to cut benefits instead of raising UI taxes. After all, each dollar of tax cut delivers $1 of value to constituents, while each dollar of benefits lost costs constituents only $1 - t$ dollars.

None of this is to say that every bad policy that produced the UI collapse was the result of deliberate schemes by state legislatures to undercut UI. My point instead is that policy inertia afflicts many programs, even those of great social importance.[179] I've argued that inertia seems more likely to creep in as the present returns to legislating seem smaller for each individual legislator, when the beneficiaries are a diffuse group or reside in other states, or when there are sometimes organized interests who stand to lose from modernization.[180] These seem likely explanations for why, for instance, the UI system has never adapted to the rise of part-time work.

## IV. EXISTING PROPOSALS TO REFORM UI FUNDING: THE GOOD, THE BAD, THE POLITICALLY IMPOSSIBLE

In this Part I will examine a set of existing proposals to reform UI. My argument here is that a successful "fix" for the UI funding system has to account for all of the potential sources of pressure I've just described. Advocates have put forward proposals aimed only at remedying moral hazard and pure exit pressure. If myopia is an important factor, then these proposals may fail to bring fiscal stability to UI. One major proposal, however, likely would also help to respond to myopia, as consideration of behavioral economics theory will illustrate.[181]

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178. *See* WILLIAM J. BAUMOL & WALLACE E. OATES, THE THEORY OF ENVIRONMENTAL POLICY 32–35 (Cambridge Univ. Press 2d ed. 1988) (1975).

179. GUIDO CALABRESI, A COMMON LAW FOR THE AGE OF STATUTES 93–101 (1982); William J. Stuntz, *The Pathological Politics of Criminal Law*, 100 MICH. L. REV. 505, 549, 554 (2001).

180. In this respect, my story is similar to the more general account of social welfare programs offered by Jacob S. Hacker, *Policy Drift: The Hidden Politics of US Welfare State Retrenchment*, *in* BEYOND CONTINUITY: INSTITUTIONAL CHANGE IN ADVANCED POLITICAL ECONOMIES 40, 45–49 (Wolfgang Streeck & Kathleen Thelen eds., 2005).

181. In addition to the finance-oriented proposals described here, the CBO in 2012 put forward several ideas to improve the incentives UI benefits provide workers. CONG. BUDGET OFFICE, *supra* note 7, at 18–21. These kinds of design features are beyond the scope of my analysis here.

### *A. Nationalize UI*

In light of the central roles that federalism plays in nearly all UI's woes, it stands to reason that some commentators would suggest that UI should simply be taken out of the hands of states, and financed and administered solely by the federal government.[182] 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.[183] For the most part, these proposals are put forward as theoretically sensible but politically unachievable.[184] My argument in this sub-part is that both these claims may be at least a little off base. There are some theoretical justifications for decentralized UI. And, far from requiring a radical political shift, nationalizing UI could largely be achieved by doing nothing at all.

First, the politics. We are already on a path at least to national financing of UI. "Pay as you go" financing philosophies, which most states have been creeping towards, essentially accept that states will always draw on federal funds in times of high benefit demand. If these borrowings are periodically forgiven or repaid with little interest, as they were in some part in 2010 and 2011,[185] 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. As of this writing, the UI trust fund is still repaying its Great Recession debts to the federal Treasury.[186] To complete a move to genuine federal financing, federal tax rates would probably have to rise. While financing is only half the UI equation, these steps towards greater federal financial responsibility would likely create some policy pressure to give the federal government more of a role in setting and adjudicating benefit eligibility.

A common argument against arrangements of this kind—when states determine benefits but the federal government pays—is that they lead to

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182. Thomas E. West & Gerard Hildebrand, *Federal-State Relations*, *in* UNEMPLOYMENT INSURANCE IN THE UNITED STATES: ANALYSIS OF THE POLICY ISSUES 545, 546–47 (Christopher J. O'Leary & Stephen A. Wandner eds., 1997); Mashaw, *supra* note 88, at 10; *see also* FURMAN, *supra* note 15, at 9 (describing the Obama Administration's proposal).

183. ACUC, *supra* note 6, at 28–29.

184. Vroman & Woodbury, *supra* note 125, at 265–66; *see* Baicker et al., *supra* note 155, at 242 (arguing that Congress likely would not have enacted a purely federal UI program).

185. ALISON M. SHELTON, CONG. RESEARCH SERV., R40368, UNEMPLOYMENT INSURANCE PROVISIONS IN THE AMERICAN RECOVERY AND REINVESTMENT ACT OF 2009, at 9 (2009).

186. Jake Grovum, *Could States Afford Jobless Benefits if Another Recession Hits?*, PEW CHARITABLE TR.: STATELINE (Apr. 22, 2015), https://www.pewtrusts.org/en/research-and-analysis/blogs/stateline/2015/4/22/could-states-afford-jobless-benefits-if-another-recession-hits.

excessive benefits, but this may well be desirable when the alternative is a race to the bottom.[187] 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.[188] 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. Even if benefits rules eventually were to migrate to the federal government, the initial 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.

On the other hand, the moral hazard effects of federal funding might change the ways that states regulate. In the parallel debate over health insurance, an argument against nationalization is the effects of national funding on state regulation of the business of health care.[189] 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.[190] 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.[191]

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,

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187. Robin Boadway et al., *The Consequences of Overlapping Tax Bases for Redistribution and Public Spending in a Federation*, 68 J. PUB. ECON. 453, 464 (1998).

188. *Cf.* Weingast et al., *supra* note 156, at 656 (arguing that the budgetary impact of individual spending decisions is an externality for each individual legislator).

189. Abigail R. Moncrieff, *Federalization Snowballs: The Need for National Action in Medical Malpractice Reform*, 109 COLUM. L. REV. 844, 862–72 (2009).

190. *Id.* at 862–64.

191. *See* Galle & Stark, *supra* note 8, at 618 (making this point about a proposal for a nation-wide rainy-day fund); Super, *supra* note 167, at 2557 (arguing that raising money at one level of government to be spent by another "tends to be unsustainable").

such as through voter discontent.[192] 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.[193]

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, even if federal loans are available.[194] Therefore, further slippage towards federalization is probably undesirable, unless we can determine with confidence that nationalization would bring better outcomes.

### *B. Ex Post Remedies*

So instead we will need to fix our current system of decentralized financing, and to do that we have to grapple with myopia. One major way in which most extant reform proposals neglect the role of myopia is in the preference of some for what I will call "ex post" incentives. For example, reformers have repeatedly suggested the possibility of paying states higher rates of interest on money deposited into their UI Trust Fund accounts.[195] The Advisory Committee on Unemployment Compensation proposed funding this incentive with small penalties on low balances.[196] Wayne Vroman, probably the country's leading authority on UI, also suggests denying bail-out loans to states that failed to accumulate an adequate Trust Fund balance or otherwise "gam[ed] the system."[197] New regulations, enacted in 2010 and to take effect fully in 2019, will condition state access to interest-free federal loans on maintaining Trust Fund balances for a period prior to the borrowing.[198]

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192. *See* Galle & Stark, *supra* note 8, at 614–16 (discussing possible present incentives for officials to save for the future).

193. On the basic theory that officials will avoid risky innovation, see Susan Rose-Ackerman, *Risk Taking and Reelection: Does Federalism Promote Innovation?*, 9 J. LEGAL STUD. 593, 596–603 (1980), and for discussion of competing possibilities, see Brian Galle & Joseph Leahy, *Laboratories of Democracy? Policy Innovation in Decentralized Governments*, 58 EMORY L.J. 1333, 1371–97 (2009).

194. For historical evidence, see ACUC, *supra* note 6, at 6.

195. ACUC, *supra* note 6, at 11; LEACHMAN ET AL., *supra* note 2, at 3, 14; Vroman, *supra* note 14, at 10.

196. ACUC, *supra* note 6, at 11.

197. Vroman, *supra* note 14, at 11.

198. Federal-State Unemployment Compensation Program; Funding Goals for Interest-Free Advances, 75 Fed. Reg. 57,146 (proposed Sept. 17, 2010) (to be codified at 20 C.F.R. pt. 606).

Myopia likely makes these incentives relatively ineffective. Interest deposited into Trust Fund accounts 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.[199] If subsidies will be delayed, they likely must be more costly for the federal government. Further, to the extent that states are myopic to differing degrees, a portion of these increased subsidies will overpay the more patient states.[200]

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 $\beta\delta u_n$, where $u$ is the utility from consumption in period $n$, delta is a standard discount rate, such as is produced by a market rate of interest, and beta is a special discount between zero and one that the individual applies only to future consumption.[201] A rational, unbiased actor allocating resources across time maximizes current consumption subject to future consumption, $u_1 + \delta u_2 + \delta^2 u_3 + \ldots \delta^n u_n$. But the present-biased actor excessively discounts future consumption, maximizing instead $u_1 + \beta\delta u_2 + \beta\delta^2 u_3 + \ldots \beta\delta^n u_n$. Other forms of excessive discounting are also possible.[202] For example, if excessive discounting compounds in the manner of ordinary interest (say, 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 $u_1 + \beta\delta u_2 + \beta^2\delta^2 u_3 + \ldots \beta^n\delta^n u_n$.

It can be shown through some algebra and basic assumptions that, in this hyperbolic discounting model, a federal government that does not hyperbolically discount (or does not discount as steeply) can save a great deal of money by offering present rather than future awards. A further exposition for those of mathematical bent is set out in the margin.[203] More generally, the

199. In addition, as we have seen, 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. Galle & Stark, *supra* note 8, at 630–31, 640. Yet another concern with bonus interest payments is that they may simply crowd out states' own contributions, resulting in little net increase in Trust Fund balances.

200. Brian Galle, *The Tragedy of the Carrots: Economics and Politics in the Choice of Price Instruments*, 64 STAN. L. REV. 797, 820–21 (2012).

201. I follow here the standard beta-delta model for hyperbolic discounting. *See* Frederick et al., *supra* note 44, at 179–81; David Laibson, *Golden Eggs and Hyperbolic Discounting*, 112 Q.J. ECON. 443, 445–46 (1997).

202. Benedek Nagy, *Hyperbolic Discounting and Economic Policy*, 10 REV. ECON. PERSP. 71, 76–81 (2010) (offering a general model of many possible hyperbolic discount functions).

203. 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 $\beta^n\delta^n u_n(g) + u_0(D(i_1 - i_2))$ -

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. In the terms of the last paragraph, a present subsidy or penalty $\alpha_u$ is the equivalent, for a hyperbolic discounter, of a future incentive $\beta^n\alpha_r$. Since beta is a fraction, this means the present incentive can be much smaller.

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.[204] Proposals to tinker with the borrowing system, as in the new regulation and the suggestion in the Urban Institute proposal to deny loans to states that have not saved adequately,[205] may likewise be less effective than expected because contemporaneous officials will greatly discount the expected cost of any future penalty.

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.[206] Individual employees may have

$u_0(\delta^n g)$. $D$ 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 $n$. Unbiased officials can be represented similarly, but will lack the $\beta^n$ term.

Now let α represent a matching grant to the jurisdiction in some proportion between zero and one. The subsidy changes the official's present utility to $\beta^n\delta^n u_n(g) + u_0(D(i_1 - i_2)) - u_0((1\text{-}\alpha)\delta^n g)$. If the utility function in period $n$ is the same as in the present (i.e., officials are risk-neutral on this dimension), then by simple algebra, the subsidy level needed to induce savings for an unrestricted grant is: $\alpha_u \geq 1\text{-}\ \beta^n - ((D(i_1 - i_2)) / \delta^n g)$. Unless both $\beta^n$ 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 required 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 $\alpha_u = \beta^n\alpha_r$.

204. *See supra* text accompanying notes 127–31.

205. Vroman, *supra* note 14, at 11.

206. *See* Levinson, *supra* note 169.

psychological reasons for neglecting the future, as an extensive empirical literature now documents.[207]

Finally, on this front, it should be mentioned that threats of penalties that will be payable during or shortly after a recession are generally not credible, for reasons that are fairly well understood.[208] 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. Knowing this, even forward-looking state actors are unlikely to be deterred by the threat of future penalties.

### *C. Conditional Forgiveness of Existing Loans*

A set of options that better accounts for the myopia problem are suggestions to leverage states' existing loan balances. Thirty-six states borrowed against the federal trust fund during the Great Recession, peaking at a total of about $51 billion in federal borrowing in 2011.[209] Even now, at the date of this writing in 2017, seven states remain in debt, with about $4 billion in debt to the federal government outstanding.[210] Proposals from the Obama Administration and the National Employment Law Project ("NELP") in 2010 and 2011 recommended 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.[211] Critics reportedly were 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.

207. *See* Frederick et al., *supra* note 44, at 164–66.

208. Jonathan Rodden, *Market Discipline and U.S. Federalism*, *in* WHEN STATES GO BROKE: THE ORIGINS, CONTEXT, AND SOLUTIONS FOR THE AMERICAN STATES IN FISCAL CRISIS 123, 126 (Peter Conti-Brown & David A. Skeel, Jr. eds., 2012).

209. DIV. OF FISCAL & ACTUARIAL SERVS., *supra* note 129, at 3, 5.

210. *Id.*

211. LEACHMAN ET AL., *supra* note 2, at 14; *see also* Unemployment Insurance Solvency Act of 2011, S. 386, 112th Cong. § 7 (2011).

1. Save More Tomorrow

Critics of loan forgiveness have overlooked some important recent lessons of the literature on behavioral economics. Myopic officials are not necessarily acting irrationally, from the perspective of their own narrow self-interest. But whatever their motive, they behave much like individuals who irrationally fail to save for retirement. Tools aimed at irrationally myopic individuals can also be applied to rationally myopic states.[212]

One key policy recommendation, first offered by Professors Shlomo Benartzi and Richard H. Thaler, is the "Save More Tomorrow" plan.[213] Individuals are more willing to commit their future selves to retirement savings than they are to commit themselves.[214] As long as the employer is willing to enforce this promise against the future self, the result is still a more comfortable retirement. Conditional loan forgiveness can leverage this insight by forgiving loans in exchange for a state's agreement to improve its trust fund balance in the future, rather than right away. In this way, modest loan forgiveness can buy significant future fiscal commitments.[215]

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, $u_o(g)=\beta^n\delta^n u_n(g)$, where $g$ is government spending and $u_n(g)$ the official's utility function in a given period. For simplicity assume that utility functions in the present and in period $n$ are identical, and represent a linear transformation of dollars to utility.[216] If the prevailing interest rate is 10% then by the standard present-value equation, 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 $\frac{1}{1+interest\ rate}$, so $\delta$=.909.

212. *See* Brian Galle, *What's in a Nudge?*, 3 ADMIN. L. REV. 1, 16 (2018).

213. Benartzi & Thaler, *supra* note 54, at 100; *see also* RICHARD H. THALER & CASS R. SUNSTEIN, NUDGE: IMPROVING DECISIONS ABOUT HEALTH, WEALTH, AND HAPPINESS 114–17 (2d ed. 2009).

214. THALER & SUNSTEIN, *supra* note 213, at 114–17; Benartzi & Thaler, *supra* note 54, at 100.

215. I don't mean to suggest that defining and enforcing state commitments will necessarily be straightforward. For discussion of some difficulties and their solutions in the public pension context, see Monahan, *supra* note 165, at 154–68.

216. That is, assume the government is risk-neutral. This is probably wrong. Intuitively, the point of UI trust funds is to transfer money from times when its marginal utility for voters is high, on average, to when it is lower. *See* Karni, *supra* note 45, at 448. If officials internalize this goal at all, the utility from spending a dollar in future periods should be higher than the utility of a similar dollar in the present savings period. Relaxing my simplifying assumption would reduce the magnitude of my results but not the central finding.

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. The discounted present value of period two consumption, viewed from period one, is (.909)(100), or $90.90. This is, of course, exactly the amount that the state needs to set aside to have $100 available in period two. Since states fully value future consumption, they will save adequately.

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. Officials will not spend $90.90 to obtain $45.45 in return. 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 the state would agree to any federal target savings even without the incentive of loan forgiveness, so long as savings did not have to start until period two.[217]

This unlikely result is mostly a consequence of the simplicity of the model, but it captures a key intuition. More realistically, the official in period one does not know when her contributions to the UI trust fund will pay off. If she expects they will be consumed in period four, for instance, her subjective present value is $37.55, implying that she will be willing to agree to save in period two if she is given a period-one incentive of $41.31 - $37.55=$3.76. Not zero, but still a quite small fraction of the $100 saved.

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

217. 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.

to limit the room for maneuver of the rival who drives her from office.[218] Alternately, consider that individuals often exhibit demand for "commitment devices" to help them overcome their own impatience, and in some cases have been observed to pay a premium for commitment services.[219] Signing onto UI finance reform may be a desirable commitment device for some state-level actors.

A potential difficulty, however, is that states may vary in the extent of their myopia. If so, a uniform federal loan forgiveness program might be overly generous to states that are the least myopic. The result could be money wasted that could have gone to the federal Treasury, or perhaps that might even encourage over-savings. These are wrinkles that have not garnered any attention in the existing proposals.

One potential solution would be for the federal government to offer both standard and "Save More Tomorrow" grants and allow states to reveal their "type" by opting into one or the other.[220] By observing state responses and calibrating the payment ratios of the two programs, federal administrators could help to trim the amount of money spent unnecessarily to overcome present bias: the central government could offer increasingly steeply discounted present payments, but use the alternative of standard pay-now, save-now contracts as a backstop to ensure that states will still save.

### 2. 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. Carrots and "sticks," or penalties, are often similar in their marginal substitution effects—either way, ignoring the government's $1 incentive leaves you a dollar poorer—but can also diverge considerably on other grounds.[221] In brief, carrots and sticks differ in their impact on income effects, in their effects on government revenues, in their distributive impact, in the psychological response of human actors, and in the incentives they create for strategic behavior.[222] Most of these factors clearly favor sticks over

218. Gary A. Wagner, *Political Control and Public Sector Savings: Evidence from the States*, 109 PUB. CHOICE 149, 150 (2001); *cf.* H. Abbie Erler, *Legislative Term Limits and State Spending*, 133 PUB. CHOICE 479, 486–88 (2007) (finding that legislative term limits increase spending).

219. Madrian, *supra* note 10, at 673–75.

220. Galle & Stark, *supra* note 8, at 630.

221. Galle, *supra* note 200, at 813–27.

222. *Id.*

carrots, except that, as I have shown in earlier work, the choice is much closer in the positive externality context.[223]

Prior analysis of the carrot vs. stick question, 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.[224] 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.[225]

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. In the specific context of UI, carrots look to score well on the revenue criterion. State-level taxes on mobile businesses are probably among the most economically distortive available, so replacing those funds with general federal tax dollars (or even federal UI tax dollars) is very likely to be a significant improvement in the efficiency of the overall tax system.

Income and output effects could also favor carrots. An income effect is simply a change in demand due to changes in wealth, while an output effect is a change in the amount of capital invested in an industry, and hence its supply of the affected goods, as a result of penalties or subsidies.[226] 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,[227]

223. *Id.* at 831–38.

224. *Id.* at 814. If, however, carrot recipients have to engage in costly behavior to receive their reward, there could be a contrary argument that carrots efficiently spread these costs across all taxpayers. *See* Gerrit de Geest & Giuseppe Dari-Mattiacci, *The Rise of Carrots and the Decline of Sticks*, 80 U. CHI. L. REV. 341, 373 (2013).

225. 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.

226. Galle, *supra* note 200, at 816–17.

227. Roger D. Congleton, *The Median Voter Model*, *in* 2 THE ENCYCLOPEDIA OF PUBLIC CHOICE 382, 385 (Charles K. Rowley & Friedrich Schneider eds., 2004) ("Government services are generally normal goods . . . .").

which perhaps would reduce the extent to which states would face pressure to offset any contributions to UI savings with cuts in general revenues.

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 savings by infra-marginal states—again, this is the issue that less myopic states may not need to be paid to save, so that incentive dollars given to them are wasted.[228] This crowd-out, however, 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.[229] To the extent that the federal government can credibly threaten sticks in these cases, states would have the opposite set of incentives.

### *D. Broadening the Federal Tax Base?*

Another worthwhile proposal by the Obama Administration and many others would increase the wage base for federal tax purposes and continue to adjust it upwards over time.[230] Legislation proposed in 2011, The UI Solvency Act, also would have expanded the base in exchange for partial forgiveness of state Trust Fund loans.[231] Again, FUTA has since 1983 been imposed on the first $7000 of each worker's wages. By federal law, state wage tax bases must equal or exceed the federal base.[232] NELP lawyers 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.[233] NELP also suggests 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.[234]

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228. Galle, *supra* note 200, at 820–21.

229. *See* Edward M. Gramlich, *Infrastructure Investment: A Review Essay*, 32 J. ECON. LITERATURE 1176, 1191 (1994) (describing how states delay capital projects in order to entice federal grant makers).

230. CONG. BUDGET OFFICE, *supra* note 7, at 23; ACUC, *supra* note 6, at 13; FURMAN, *supra* note 15, at 10; LEACHMAN ET AL., *supra* note 2, at 12–13; Vroman, *supra* note 14, at 9–10.

231. Unemployment Insurance Solvency Act of 2011, S. 386, 112th Cong. § 5 (2011).

232. U.S. GOV'T ACCOUNTABILITY OFFICE, *supra* note 12, at 11.

233. LEACHMAN ET AL., *supra* note 2, at 12–13.

234. *Id.* at 13. 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

The logic of this claim is a bit unclear.[235] 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.[236] Many state tax codes mirror federal law, and in a number of instances states have failed to respond even to federal changes that seem to disadvantage them.[237] But in others, states do respond promptly, as in the case of certain federal accelerated depreciation deductions, which a number states quickly disclaimed.[238] Probably most states would eventually adjust their rates downwards, but if there were annual federal base expansions there would likely be lag periods in which state revenues would begin to rise.

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.[239] Raising that figure

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necessarily the case for FUTA. The federal minimum wage puts lawful full-time workers at well above $7000. FUTA therefore operates as something like a flat tax on full-time work, and therefore impacts only the extensive margin of labor/leisure decisions. 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. On the other hand, a cap below the full-time minimum wage threshold does tend to encourage businesses to hire full-time over part-time workers. CONG. BUDGET OFFICE, *supra* note 7, at 23.

Another virtue of broadening the base is that it might improve the progressivity of the tax. CONG. BUDGET OFFICE, *supra* note 7, at 23; ACUC, *supra* note 6, at 13. Whether this is so depends on the extent to which employers would pass through more UI taxes to workers who earned more, or instead simply passed through something like an average UI tax burden to each worker. Even assuming base-broadening would achieve progressivity, 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 $7000. *See* Feldstein, *supra* note 50, at 3 (observing that this structure makes UI regressive). Lower-wage workers could be given a higher replacement rate, for example.

235. The first recommendation for base-broadening was apparently based on the empirically naive observation that states with broader bases had a more robust Trust Fund balance. ACUC, *supra* note 6, at 40. While this relation could be causal, it is equally possible that some third unobserved variable, such as the state's culture of fiscal responsibility or the strength of its unionized work force, explains both results.

236. States that index their tax base to inflation borrowed much less during the Great Recession. VROMAN, *supra* note 124, at 3. A possible implication is that states do not periodically lower tax rates as their tax base grows, resulting in more revenue.

237. *See* Ruth Mason, *Delegating Up: State Conformity with the Federal Tax Base*, 62 DUKE L.J. 1267, 1274–79 (2013).

238. *See* Ruth Mason, *Federalism and the Taxing Power,* 99 CALIF. L. REV. 975, 1020–21 (2011).

239. TONY FIORE, UWC—STRATEGIC SERVS. ON UNEMPLOYMENT & WORKERS' COMP., SUCAP LEGISLATIVE ADVISORY 20 (2014), http://www.uwcstrategy.org/wp-content/uploads/bsk-pdf-manager/1_2014_JULY_SUCAP_REPORT.PDF.

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 in part on whether one favors sticks over carrots: do we want a bigger penalty on states that don't save? I've suggested the ex post nature of the penalty and the fact that it can occur during recession and recovery periods argue against it.[240] Further expansion of the unpaid debt penalty is probably undesirable unless its timing and structure were totally overhauled.

If continuing expansion of the federal wage base is nevertheless 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. NELP does not explain how it 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 or agency-adjusted rates, especially in the energy tax context.[241]

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Overall, the UI reform proposals on the table to date do offer the possibility of incremental improvements, especially if they are tweaked to better reflect the myopic nature of state government. Each of them, however, also carries risks. It is worth considering some additional options.

## V. NEW PROPOSALS

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

240. *See supra* text accompanying notes 203–08.

241. *E.g.*, Thomas W. Merrill & David M. Schizer, *Energy Policy for an Economic Downturn: A Proposed Petroleum Fuel Price Stabilization Plan*, 27 YALE J. ON REG. 1, 9 (2010).

in which one problem was more acute than the others, we could tailor remedies to those instances.

### *A. 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.[242] The main appeal of a tax option is that it would be a stick, not a carrot. In other words, the tax is likely to be most appealing in the event that pure subsidization strategies are found to create too much moral hazard, a possibility I mentioned in IV.C.2, above. 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. Where the first option merely compels the state to allocate its money in a way its officials do not prefer, the second actually takes money out of state coffers. The first alternative is likely to be fairly painful for state officials. Officials are already 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.[243] Nor will returning the money to the state soften the anger of taxed employers. Since the state's Trust Fund is effectively a common pool for the state's employers, none have strong incentives to care about Trust Fund balances.[244]

Either way, the penalty tax on employers accounts for all three UI failures. As we've seen, 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.[245] Further, if imposed directly on employers

242. The Center for American Progress has offered a one-paragraph description of a possible tax on low balances. HEATHER BOUSHEY & JORDAN EIZENGA, CTR. FOR AM. PROGRESS, TOWARD A STRONG UNEMPLOYMENT INSURANCE SYSTEM: THE CASE FOR AN EXPANDED FEDERAL ROLE 10 (2011), https://cdn.americanprogress.org/wp-content/uploads/issues/2011/02/pdf/ui_brief.pdf.

243. BRIAN D. GALLE, MYOPIA, FISCAL FEDERALISM, AND UNEMPLOYMENT INSURANCE: TIME TO REFORM UI FINANCING 14 (2012), https://lawdigitalcommons.bc.edu/lsfp/415/.

244. *Cf.* Weingast et al., *supra* note 156, at 643 (describing political economy dynamics of budgetary pools).

245. Galle & Stark, *supra* note 8, at 630–31.

they avoid whipsawing the state official between her federal incentive to save and employer political pressure to cut taxes.

In earlier work with Kirk Stark, I cautioned against a similar form of federal control in the context of state contributions to rainy-day funds.[246] 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.[247]

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 assessed against employers, not the state, there is no obvious distortion in the state's incentive to set its own tax rates. Finally, our central point was that the role of the federal government should be to set prices in such a way as to incentivize states to utilize each state official's superior information and political connections to local actors, rather than simply having the federal government declare the best policy.[248] Taxes on low balances accomplish that goal, since states remain free to maintain low balances if that is optimal, taking into account the tax.

### *B. 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 (or other key metrics, see V.C., below) exceeded a target threshold, such as 75% of national-average expected annual cost.[249] To avoid cliffs, both penalty and supplement could be phased in, perhaps with a region in between where neither would apply.[250] One way of

246. *Id.* at 620–21.
247. *Id.* at 621.
248. *Id.* at 620–21.
249. NELP also mentions this possibility. LEACHMAN ET AL., *supra* note 2, at 14.
250. On the superiority of graduated incentives over steep cliffs or kinks, see Joel Slemrod, *Buenas Notches: Lines and Notches in Tax System Design*, 11 EJOURNAL TAX RES. 259, 275, 277

implementing the employer bonus would be to allow employers' state UI taxes to be deductible from their federal UI ("FUTA") payments.[251]

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—recall that employer lobbying creates personal stakes for each individual legislator. However, both of these features could perhaps be replicated with other forms of grants to the state. For example, as Prof. Stark and I 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.[252]

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 (using a bonus for high fund balances) and maximizing the political efficacy of the federal incentive (using unrestricted federal grant funds, which could be used to finance state-level tax cuts). Without better information about the political economy of state UI funding, 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.

### C. *Revenue Targets Rather than Fund Balances*

As we saw in Part III, a critical problem with the existing UI system is that federal efforts to make states care about their trust fund balances tend to produce cuts to benefits, rather than greater revenues.[253] Without some further fix, this same problem would be true of both of my proposals so far, as well as with a number of those offered by others. In particular, states can meet any incentive keyed to their Trust Fund balance by cutting payouts.[254] Further, if

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(2013); David A. Weisbach, *An Efficiency Analysis of Line Drawing in the Tax Law*, 29 J. LEGAL STUD. 71, 76–77 (2000).

251. 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. Vroman, *supra* note 14, at 7. 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 align state incentives properly.

252. Galle & Stark, *supra* note 8, at 630.

253. The Advisory Council on Unemployment Compensation sought and failed to find a satisfactory solution to this problem. *See* ACUC, *supra* note 6, at 6, 12–13.

254. *See* U.S. GEN. ACCOUNTING OFFICE, *supra* note 6, at 31–32.

account-balance targets are experience rated in some way—that is, if target trust fund amounts depend on past benefit levels—then states have incentives to hold down expenditures in order to make their future targets easier to reach.[255]

Maintenance-of-effort rules are a traditional solution to this problem, but few commentators believe that they have ever really been successful.[256] Evidence suggests that governments can game MOE rules by using offsetting transfers outside the budget area controlled by the rules. For instance, Gordon 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.[257] 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 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.[258] 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. The DOL 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. Contributions could be held together in a pool that was available to all the states, or each state could continue to

255. *Cf.* Richard Sansing & Robert Yetman, *Governing Private Foundations Using the Tax Law*, 41 J. ACCT. & ECON. 363, 365 (2006) (reporting that private firms subject to a tax that varies based on past expenditures sometimes manage spending to reduce future tax).

256. Alexander Cowell, Dennis McCarty & Albert Woodward, *Impact of Federal Substance Abuse Block Grants on State Substance Abuse Spending: Literature and Data Review*, 6 J. MENTAL HEALTH POL'Y & ECON. 173, 177 (2003); Roderick M. Hills, Jr., *The Political Economy of Cooperative Federalism: Why State Autonomy Makes Sense and "Dual Sovereignty" Doesn't*, 96 MICH. L. REV. 813, 936 (1998); Super, *supra* note 167, at 2569.

257. Nora Gordon, *Do Federal Grants Boost School Spending? Evidence from Title I*, 88 J. PUB. ECON. 1771, 1772–73 (2004).

258. A possible slogan: "Every state must do its PART to fight recessions." If you just groaned, reader, then you have confirmed my earlier claim that academics do not understand politics.

maintain its own pool, but with the possibility of interstate trust-fund loans on generous terms if some states are hit harder by recession than others.[259]

A brief numerical example might be useful. Suppose the nation's total expected UI outlays in the next recession of average depth is $100 billion. If states have only $15 billion in their trust funds, then the national shortfall is $85 billion. If California has 10% of the U.S. population,[260] it will have to contribute $8.5 billion in savings, or about $2.1 billion per year. Under my combined tax/reward program, California employers would pay an extra UI tax if California contributes less than its $2.1 billion PART to its trust fund, and would get a bonus if California well exceeded that number.

To further account for regional variation and moral hazard, states could also be experience-rated. DOL would make adjustments to PART contributions to reflect historical patterns of job turnover in the state.[261] In this way, states with, say, migrant workers or large numbers of bureaucrats would need to save more or less, respectively. The idea is to give states incentives to regulate their economies in a way that accounts for the UI consequences of the state's choices.

A potential distortion the PART system brings, albeit one that is desirable in my view, is that it may tend to encourage moral hazard in the provision of UI benefits. A state increases the national expected cost of benefits when it enacts broader benefit provisions or is less strict in policing existing eligibility rules. Under the PART system, each state will cover its own increased expenses in the routine course of events. In recessions, however, when states draw on reserve funds, some portion of the new benefits will in effect be paid by other states, perhaps offering an incentive to current legislators to be more generous.

If PART indeed encourages expanded benefits in this way, that would be a positive development. Given the political economy of sub-national UI funding I outlined earlier, there is reason to suspect state decisions about benefit levels will fall far below the national optimum.[262] It is doubtful that even extensive federal co-funding would fully offset this under-provision.

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259. *Cf.* Vroman, *supra* note 14, at 10 (describing the possibility of rewarding states for lending money to other states).

260. It's actually currently around 12%, but let's make the math easy.

261. Many states will include large segments of the population who work in metro areas shared with another state. For more precision, the economic-conditions adjustment could replace state-level tracking with weighted allocations of metropolitan statistical area (MSA) statistics. That is, the state numbers would represent the cumulated numbers in the rural and metropolitan statistical areas within the state, with portions of each MSA's results allocable to the state by the portion of state population in each such MSA.

262. *See supra* text accompanying notes 139–54.

For example, in the Medicaid context, there is evidence of a "race to the bottom" in state spending, notwithstanding very generous federal matching grants.[263]

Changing over to a PART system also raises some questions about transition policy. Some states, although not many, already have enough money saved to meet their own expected needs.[264] My proposal would incentivize these states to save yet more, in order to cover for the bad fiscal straits of their neighbors. That is true, but not necessarily a flaw. States that already have strong records of savings are effectively infra-marginal, and so in fact should receive a lower subsidy.[265] States with persistently poor savings records may have few resources or face especially intense intra-jurisdictional fiscal competition, thereby meriting more federal aid.

To be sure, a shift this dramatic would likely require yet more policy details to be resolved, but more and deeper thinking in this direction is needed. All the proposed "solutions" to UI's problems, including "Save More Tomorrow" loan forgiveness pledges, to the extent that they rely on trust fund balances, have the potential to undermine benefits, further hollowing out the UI system. It is therefore crucial that UI's fiscal health be de-linked from the generosity of benefits. PART offers one path to this result, but undoubtedly others are available.

### *D. Increase Federal Involvement in Rules and Administration*

So far, my discussion has focused principally on the financing of the UI program, on the theory that states' fiscal incentives have been mostly responsible for their substantive policy choices. If these financing reforms are off the table for whatever reason, we might consider policies that treat the

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263. Michael A. Bailey & Mark Carl Rom, *A Wider Race? Interstate Competition Across Health and Welfare Programs*, 66 J. POL. 326, 344–45 (2004); *see also* Jan K. Brueckner, *Welfare Reform and the Race to the Bottom: Theory and Evidence*, 66 S. ECON. J. 505, 522–23 (2000) (finding some evidence for this effect in welfare spending); Craig Volden, *The Politics of Competitive Federalism: A Race to the Bottom in Welfare Benefits?*, 46 AM. J. POL. SCI. 352, 354–55 (2002) (also finding some evidence for this effect in welfare spending); Reagan Baughman & Jeffrey Milyo, How Do States Formulate Medicaid and SCHIP Policy? Economic and Political Determinants of State Eligibility Levels 15–17 (2009) (unpublished manuscript) (on file with Pennsylvania State University) (finding some evidence that state Medicaid policy is influenced by generosity of neighbors).

264. DIV. OF FISCAL & ACTUARIAL SERVS., *supra* note 129, at 3, 5.

265. *See* Lily L. Batchelder, Fred T. Goldberg, Jr. & Peter R. Orszag, *Efficiency and Tax Incentives: The Case for Refundable Tax Credits*, 59 STAN. L. REV. 23, 46, 52 (2006) (explaining that government should generally avoid offering incentives to actors who would undertake the action anyway).

symptoms of state dysfunction, rather than the underlying causes. Of course, we might also combine fiscal and substantive reforms, in the hopes that any unexpected weaknesses of one will be compensated for by strengths of the other. I'll mention two substantive ideas here: default federal benefits rules, and federal adjudication of benefits. Both of these share the appealing feature that they would require little or no new federal outlays, unlike some of the suggestions offered earlier.

The first, default federal benefit rules, draws on behavioral economics research. Commentators have observed that opt-out default rules share many of the features of a tax or subsidy, but without the need for dollars to change hands.[266] Some of us find it hard to motivate ourselves, especially if we must engage in cognitively challenging or uncomfortable tasks such as planning our retirement savings or deciding whether to be an organ donor.[267] Opt-out rules turn that inertia to the service of good policy by setting whichever policy regulators believe is the best for the public as the default.[268] Only by incurring the unwanted mental cost can the inert get to the less-desirable policy. Defaults have two key advantages over dollar-denominated incentives: they might reach those who are relatively unmotivated by money, and they avoid potentially undesirable redistribution of wealth.[269]

Once more, while state officials do not always act irrationally, they experience inertia in ways that make them resemble irrational individuals, so that defaults can be useful tool for influencing them. We saw earlier that state officials lack strong incentives to modernize their UI statutes and make sure that eligibility and other rules reflect the realities of the new workplaces. Typically, it is concentrated interest group activism that motivates lawmakers to overcome legislative inertia and attend to the interest group's policy area, but with the collapse of the American labor movement there are no coherent

266. Jacob Goldin & Nicholas Lawson, *Defaults, Mandates, and Taxes: Policy Design with Active and Passive Decision-Makers*, 18 AM. L. & ECON. REV. 438, 439–41 (2016); Madrian, *supra* note 10, at 668–70. Among other common elements, defaults share with taxes and subsidies the feature that they preserve choice—instead of replacing state decisions, the federal government merely structures state decisions in a way that encourages the state actor to internalize all relevant costs. Galle, *supra* note 10, at 854–55, 862–64.

267. *See* Frederick et al., *supra* note 44, at 172–78.

268. *See* Goldin & Lawson, *supra* note 266.

269. Galle, *supra* note 10, at 872–74, 880–83.

groups to play that role for the UI system.[270] In 2009, Congress paid states $7 billion to undertake some UI modernization.[271]

I suggest that instead of money, inertia can be turned to public use by placing primary responsibility for UI program details in the hands of the DOL, but allowing states to opt out at will. In other words, DOL regulations would establish all the rules for UI eligibility that currently are controlled only by states. States could choose to replace DOL's rules through their own legislation, either individually or en masse. This residual state authority might make federal standard-setting more politically acceptable than an outright takeover, which again most commentators view as politically impossible.[272]

While federal bureaucracies are not necessarily the most nimble of institutions, they face fewer obstacles to policy change than most legislatures.[273] DOL also has the advantages of in-house expertise, information flowing in from all fifty states, and insulation from direct political pressure by mobile businesses.[274] Federal agencies of course are not immune to political influence, but administrative law and judicial review lead to greater transparency in their decisions, as well as greater reliance on facts and reasoned decision making rather than lobbyists' preferences.[275]

In a sense the default rules are a compromise between two other alternatives we've already covered: penalties and subsidies. Unlike a subsidy, the default rule is unlikely to cause crowding out or moral hazard, because the state gains little of value by failing to opt out (other than getting a better UI policy, but by assumption the state undervalues that goal).[276] And unlike

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270. *See* William N. Eskridge, Jr., *Politics Without Romance: Implications of Public Choice Theory for Statutory Interpretation*, 74 VA. L. REV. 275, 280–94 (1988) (describing public-choice theories of legislative process).

271. JULIE M. WHITTAKER & KATELIN P. ISAACS, CONG. RESEARCH SERV., RL33362, UNEMPLOYMENT INSURANCE: PROGRAMS AND BENEFITS 3–4 (2016), https://fas.org/sgp/crs/misc/RL33362.pdf.

272. Vroman & Woodbury, *supra* note 125, at 265–66; *see* Baicker et al., *supra* note 155, at 242–43.

273. *See* Cass R. Sunstein, *Law and Administration After* Chevron, 90 COLUM. L. REV. 2071, 2088 (1990).

274. Catherine M. Sharkey, *Products Liability Preemption: An Institutional Approach*, 76 GEO. WASH. L. REV. 449, 485 (2008); *see* Gillian E. Metzger, *Administrative Law as the New Federalism*, 57 DUKE L.J. 2023, 2062–63 (2008); *cf.* CONG. BUDGET OFFICE, *supra* note 7, at 22 (noting that allowing more federal standardization of UI benefits rules could reduce economic distortions caused by business efforts to avoid state-level UI taxes).

275. Brian Galle & Mark Seidenfeld, *Administrative Law's Federalism: Preemption, Delegation, and Agencies at the Edge of Federal Power*, 57 DUKE L.J. 1933, 1974–76 (2008); Catherine M. Sharkey, *Preemption by Preamble: Federal Agencies and the Federalization of Tort Law*, 56 DEPAUL L. REV. 227, 256–58 (2007).

276. *See* Galle, *supra* note 10, at 877–78.

a penalty, the default rule does not sap needed money from state trust funds or the bank accounts of mobile businesses. Further, defaults might be able to influence states that would otherwise be indifferent to dollar-denominated incentives,[277] such as if the incentives affected the state treasury, and state officials treat that treasury as a shared pool in which they lack much individual interest.

Of course, the debate over whether policy priority should rest with states or the federal government is a long-standing one, but a default in favor of increased federal UI authority makes sense under most classic analyses. For example, as Mark Seidenfeld and I have argued in the preemption context, federal agencies likely should have greater say when there are serious spillovers across states.[278] That case is even more convincing, we say, when there is a serious likelihood that in-state interests are coherent and well-organized while those who might be harmed by the spillovers are relatively scattered and politically weak.[279] The argument for the UI default is stronger yet, because when the federal rule is only a default, not a requirement, states that are sufficiently motivated retain the freedom to act, helping to preserve both state autonomy as well as any potential benefits of experimentation.[280]

Federal default rules are not as radical an innovation as they might seem at first glance. Other programs have evolved to what is in effect a similar structure. For instance, the Medicaid program in theory sets some uniform national standards for state health insurance for the poor.[281] CMS, the agency that administers Medicaid, is authorized to grant waivers to any of these federal rules. In effect, any state with sufficient initiative can escape the Medicaid rules, although to be sure CMS does not grant every waiver.[282] Whether or not to allow states to freely alter federal defaults in the UI context, or to require approval from DOL, would be a further design component choice that deserves additional study.

Federalism values are likely also the central consideration in my second proposal, federalization of benefit eligibility determinations.[283] Here, instead

277. *Id.* at 872–74, 880–83.

278. Galle & Seidenfeld, *supra* note 275, at 1987.

279. *See id.* at 1992–93.

280. On the possible benefits from leaving states in control of UI benefits, see CONG. BUDGET OFFICE, *supra* note 7, at 22.

281. KAISER COMM'N ON MEDICAID AND THE UNINSURED, HENRY J. KAISER FAMILY FOUNDATION, MEDICAID: A PRIMER 5 (2013), https://kaiserfamilyfoundation.files.wordpress.com/2010/06/7334-05.pdf.

282. *Id*. at 5–6.

283. CBO also briefly mentions federalization of benefits administration in its 2012 white paper. CONG. BUDGET OFFICE, *supra* note 7, at 22.

of setting out the substantive rules for when benefits will be available, a federal bureaucracy will simply apply state-crafted rules (though this proposal could also be combined with default federal substantive rules as well). As I described earlier, it appears that much of the erosion in UI "recipiency," or the rate at which separated workers obtain benefits, has come from ever-decreasing rates of benefit awards, rather than solely changes in substantive state rules.[284] States may promise benefits but then deny them in opaque administrative proceedings as a way of capitulating to business pressure without arousing any popular discontent.[285] Alternately, it is possible that employers now win more often because they are repeat players who can invest in expertise at winning in a complex system. In the latter case, federalization would be unlikely to add much value, so additional empirical work would be useful to a good assessment of the proposal.

Empirics aside, the federalism case against federal administration seems weak but not lifeless. Financing is a secondary consideration, because federal UI taxes already pay for a significant portion of states' costs of claims administration.[286] Federal adjudication of state UI rules resembles removal of state-law judicial claims to federal court.[287] When the law is clear, there would seem little difference in who adjudicates the claim.[288] On the other hand, when the application of state rule to the facts at hand leaves room for judgment, it may matter who sits as decision maker. States might prefer that individuals with that authority work under circumstances of transparency, accountability, and training that differ from the choices that the federal government makes. Although the value of state experimentation has been overstated,[289] there may still be some value in observing different approaches to claims administration over time.[290]

### *E. Automatic Enrollment*

I described in Part II the ways in which individuals who might be eligible for UI fail to claim them. Reformers should consider policies that would increase the share of eligible workers who receive benefits. Helping eligible

284. *See supra* text accompanying notes 90–94.

285. *See* Super, *supra* note 92, at 840.

286. U.S. DEP'T OF LABOR, *supra* note 1, at 2.

287. 28 U.S.C. §§ 1441, 1652 (2018).

288. Dolores K. Sloviter, *A Federal Judge Views Diversity Jurisdiction Through the Lens of Federalism*, 78 VA. L. REV. 1671, 1675 (1992).

289. See Galle & Leahy, *supra* note 193, at 1360, 1397–98, for a critique.

290. ACUC, *supra* note 6, at 30.

individuals could be paternalistic, in the sense that it would aid these workers in overcoming self-imposed obstacles, but would also serve the more traditional governmental function of creating positive externalities for the beneficiary's family as well as the economy as a whole.[291]

Automatic enrollment also helps to overcome a fundamental incentive problem in the design of the UI program. In other government programs in which employers are enlisted to further social policy, employers have reason to aid the government. For instance, employer-sponsored health insurance and pensions help to overcome adverse selection in those markets; by providing these benefits, employers can capture some of society's gains in the form of lower salaries.[292] In contrast, with an experience-rated UI system, employers lose out every time one of their separated workers qualifies for benefits, providing strong incentives to discourage qualification.

Recent fieldwork in other social safety net areas has shown the power of automatic enrollment to boost benefit claim rates.[293] Automatic enrollment also bolsters private programs that help to replace the need for government assistance, such as by greatly increasing pension savings[294] and life insurance coverage.[295] And less rigorous methods suggest huge increases in benefit claiming in yet other programs, such as Medicare Part B and the National School Lunch Program.[296]

UI administrators could easily adopt similar methods. For instance, employers could be required to provide notification to the state UI system

291. *See* GRUBER, *supra* note 42, at 3 (describing market-failure theory of government regulation).

292. Brendan S. Maher, *Regulating Employment-Based Anything*, 100 MINN. L. REV. 1257, 1280–82 (2016).

293. Other federal programs, which have automatic enrollment, have demonstrated such results. *See, e.g.*, Damon Jones, *Inertia and Overwithholding: Explaining the Prevalence of Income Tax Refunds*, 4 AM. ECON. J. ECON. POL'Y 158, 159–61 (2012) (EITC); Brian E. McGarry, Robert L. Strawderman & Yue Li, *The Care Span: Lower Hispanic Participation in Medicare Part D May Reflect Program Barriers*, 33 HEALTH AFF. 856, 860–62 (2014) (prescription drug coverage for seniors); Diane Whitmore Schanzenbach, *Experimental Estimates of the Barriers to Food Stamp Enrollment* 14 (Inst. for Research on Poverty, Discussion Paper No. 1367-09, 2009), https://www.irp.wisc.edu/publications/dps/pdfs/dp136709.pdf (SNAP benefits).

294. Raj Chetty et al., *Active vs. Passive Decisions and Crowd-Out in Retirement Savings Accounts: Evidence from Denmark*, 129 Q.J. ECON. 1141, 1141 (2014); Brigitte C. Madrian & Dennis F. Shea, *The Power of Suggestion: Inertia in 401(k) Participation and Savings Behavior*, 116 Q.J. ECON. 1149, 1149–50 (2001).

295. *See* Timothy F. Harris & Aaron Yelowitz, *Nudging Life Insurance Holdings in the Workplace*, 55 ECON. INQUIRY 951, 952–53 (2016).

296. STAN DORN & GENEVIEVE M. KENNEY, COMMONWEALTH FUND, PUB. NO. 931, AUTOMATICALLY ENROLLING ELIGIBLE CHILDREN AND FAMILIES INTO MEDICAID AND SCHIP: OPPORTUNITIES, OBSTACLES, AND OPTIONS FOR FEDERAL POLICYMAKERS 6–7 (2006).

when a worker is terminated, and that individual could be automatically enrolled for UI benefits.[297] Employers could also be required to provide voluntarily separating workers with a short questionnaire on the reasons for departure, and if the employee indicates a qualifying reason, such as a spouse who has relocated for work, then the employee would also be automatically enrolled.

Many jurisdictions have additional requirements for full UI eligibility other than separation, but these could be tested after automatic enrollment has commenced. For example, after the automatic enrollment, the new benefit recipient could be contacted to verify that she is searching for work or unable to work. If mistaken payments are a concern, benefit checks could be withheld until this step has been completed. The key, however, is that verification would occur at the initiative of the UI administrator, not the worker. Individuals' inertia or mistaken beliefs about eligibility would be much less likely to prevent the receipt of benefits.

It could be argued that the cumbersome worker-initiated system for claiming benefits serves as an efficient "costly screen" or "ordeal mechanism," but that claim is hard to defend in light of the realities of UI.[298] The theory behind the costly screen argument is that making safety-net benefits difficult to claim helps to reduce moral hazard, by ensuring that only those that really "need" benefits, and so presumably are motivated to overcome the screen, can receive them.[299]

For the mechanism to work correctly, then, there must be a strong correlation between ability or willingness to deal with the hassle of obtaining benefits and the need for those benefits. In fact, for most safety-net programs, including UI, the opposite is true. Those with the lowest capacity to navigate confusing government bureaucracies—say, because of language obstacles, poor education, or cognitive difficulties—are those who also have the lowest expected earnings.[300]

The screening theory is also somewhat incoherent in a context where there are important positive externalities from benefits receipt. In a rational actor framework, the worker exerts effort to overcome red tape to the extent that she actually needs benefits, thereby preventing low-need workers from

297. There are precedents for employer-initiated applications, which in the past have sometimes accompanied mass layoffs. O'Leary, *supra* note 25, at 28. Employers already must track wages for each employee on a quarterly basis to facilitate implementation of the experience-rated tax system. Vroman & Woodbury, *supra* note 125, at 255.

298. Nichols & Zeckhauser, *supra* note 110, at 376–77.

299. *Id.* at 377.

300. *See* Cadena & Keys, *supra* note 111; Golsteyn, Grönqvist & Lindahl, *supra* note 111; *see also* Super, *supra* note 92, at 853–54; *supra* text accompanying note 111.

claiming.[301] In UI, however, workers don't internalize all the gains from qualifying, especially during recessions when fiscal externalities are large.[302] Thus, a costly screen would prevent many workers from claiming benefits even though it would be socially beneficial for that worker to be eligible.

### *F. Repeal Taxes on UI Benefits*

Readers will recall that until the early 1980s, UI benefits were exempt from state and federal taxes. As I suggested earlier, this change likely undermined state incentives to provide benefits, and may well help to explain why states prefer benefit cuts to tax hikes as a way of keeping trust funds liquid.[303] Yet another problematic aspect of taxing benefits is the obvious one that it reduces the amount of money in consumers' hands during recessions, when they and the economy need it most.[304] We should repeal the tax on UI benefits.

Unlike most of my other proposals, this is an idea that has a real federal budget cost, and might therefore be more difficult to enact. To the extent that UI benefits stimulate the economy, some of the lost tax revenue would be recaptured through increased wages and corporate income elsewhere, and lower expenditures on other safety-net programs.[305] If the budget cost is still prohibitive, it could be trimmed by making tax exemption limited to economic downturns, when the spillover benefits of UI are greatest.[306] For example, UI benefits received during any month recognized by the National Bureau of Economic Research as a "recession" could be exempt from tax, while others could be taxable.[307] Presumably workers would not be able to keep track of this, so state UI offices would have to be responsible for

301. Nichols & Zeckhauser, *supra* note 110, at 376.

302. *See supra* Part II.B.

303. *See supra* text accompanying notes 176–79.

304. Another potential argument against taxing UI benefits might be that they are a kind of "double taxation" on benefits workers have already bought with after-tax dollars, but this turns out not to be true. Workers pay into the UI system in the sense that their employers pay the UI tax, then reduce workers' wages accordingly. Since the workers never receive the lost wages, they are not taxed on them. Further, the employer can deduct its state UI taxes from its federal income tax base.

305. *See* ACUC, *supra* note 6, at 18 (noting that UI expansions are partly paid for through reduced expenditures on other programs).

306. This has precedents. For example, in 2009, Congress temporarily suspended taxes on the first $2,400 of UI benefits. CONG. BUDGET OFFICE, *supra* note 1, at 4.

307. For a discussion, see BUS. CYCLE DATING COMM., NAT'L BUREAU OF ECON. RESEARCH, THE NBER'S RECESSION DATING PROCEDURE (2008), http://www.nber.org/cycles/jan08bcdc_memo.html.

notifying workers which benefits were taxable and which were not. This would be a modest addition to the existing requirement that the state provide workers with a form stating their taxable UI benefits.[308]

Budget constraints aside, the strongest arguments in favor of taxing UI are probably tax system norms of "horizontal" and "vertical" equity.[309] If the goal of the tax system is to ask for similar contributions from individuals with similar "ability to pay" tax,[310] the argument would go, then individuals who receive UI benefits of $5,000 are no better or worse off than those who received $5,000 in wages. Of course, this same argument could also be made for any other form of government benefit, and most of them (with the limited exception of social security receipts by high-income individuals) are exempt from state and federal tax exactly because the point of the benefit is to redistribute income to the recipient.[311]

Put another way, whether to tax government benefits is not really a tax question, but instead a question about the desired size of the net benefit delivered.[312] Suppose Tommy used to work on the docks, earning $500 per week, and $400 per week after a 20% income tax.[313] His UI replacement benefits are $250 per week. If these are untaxed, he has a net replacement rate of 250/400 = 62.5%. If they are taxed at Tommy's old 20% tax rate, his net replacement rate is (.8 * 250)/400 = 50%. Whether or not taxes should be imposed, then, should turn on which of these rates is closer to optimal.[314]

308. Unemployment Compensation Amendments of 1992, Pub. L. No. 102-318, § 301 (1992).

309. Feldstein, *supra* note 50, at 14 ("[C]ash income is cash income and should be taxed."); *see* Boris I. Bittker, *A "Comprehensive Tax Base" as a Goal of Income Tax Reform*, 80 HARV. L. REV. 925, 935–38 (1967) (noting this argument, but arguing in turn that taxing UI while omitting other, unmeasurable, non-cash government benefits would raise the same problems). In general, "horizontal" equity is similar treatment of similar taxpayers, while "vertical" equity refers to the just treatment of dissimilar taxpayers. For an overview of the two, and discussion of whether these are meaningfully distinct concepts, see generally Paul R. McDaniel & James R. Repetti, *Horizontal and Vertical Equity: The Musgrave/Kaplow Exchange*, 1 FLA. TAX REV. 607, 607–09 (1993).

310. While the measurement of ability to pay is a standard approach to the appropriate tax burden, others are possible, see John R. Brooks, *The Definitions of Income*, 71 TAX L. REV. 253, 259–74 (2018), and I mean to take no position which view is most persuasive here.

311. LOUIS KAPLOW, THE THEORY OF TAXATION AND PUBLIC ECONOMICS 125–42 (2008); *cf.* William D. Andrews, *Personal Deductions in an Ideal Income Tax*, 86 HARV. L. REV. 309, 359 (1972) (suggesting that free public education is untaxed in order to encourage education).

312. *See* KAPLOW, *supra* note 311.

313. *See* BON JOVI, *Livin' on a Prayer*, *on* SLIPPERY WHEN WET (Mercury Records 1986).

314. *Cf.* Feldstein, *supra* note 50, at 14 (asserting that taxing UI benefits moves replacement rate closer to optimal).

If policy makers were nonetheless convinced that the distributive and budget impact of exempting UI were a concern, tax exemption could be enacted on a distributionally- and revenue-neutral basis.[315] That is, Congress could raise the income tax rate for the group of workers who are most likely to benefit from UI benefits, using this income to offset the costs of UI exemption. On average, each worker in that group would come out the same, with higher taxes while working and lower taxes while receiving UI. Personally, I would not favor this plan, as I believe that our current tax system is insufficiently progressive. Exempting UI benefits with no offset would tend to make our system more progressive, as the group of workers most likely to receive UI tend to be poorer than average.[316]

## 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 legislation proposed in 2011, to forgive current outstanding loan balances in exchange for state commitments to get their acts together. Even that idea, however, will likely lead to further weakening of state UI budgets, unless incentives are based on something other than Trust Fund balances. Policy ideas going forward should instead aim to solve all three of the central problems plaguing U.S. unemployment insurance, while also being careful to avoid the destructive mistakes of the past.

My focus in this paper has been on the financing and administration of the existing set of UI benefits. Others have offered ideas on the benefit side that also deserve careful consideration, such as wage-loss insurance[317] or

315. For a more complete discussion of distributionally-neutral policies, see KAPLOW, *supra* note 311, at 18–25.

316. A compromise position, similar to that now applicable to social security benefits, would be to tax benefits received by high income households. *See* 26 U.S.C. § 86 (2012) (setting out the formula for partial taxation of social security payments). The distributional case for the exemption of UI benefits is certainly weaker for a worker who shares a household with someone else who remains employed and earns a comfortable living. *See* Bittker, *supra* note 309, at 974–76; Jonathan Barry Forman, *The Income Tax Treatment of Social Welfare Benefits*, 26 U. MICH. J.L. REFORM 785, 813–14 (1994).

317. Lee Anne Fennell, *Unbundling Risk*, 60 DUKE L.J. 1285, 1322–23 (2011); Donald O. Parsons, *Wage Insurance: A Policy Review*, 2 RES. IN EMP. POL'Y 119–40 (2000); ROBERT E. LITAN, BROOKINGS INST., WAGE INSURANCE: A POTENTIALLY BIPARTISAN WAY TO HELP THE

supplementing benefit grants with low-cost government loans.[318] All of these innovations, however, depend on a reliable source of financing. Before we can remake UI benefits for the next century, we first have to correct the UI financing errors of the last one.

Finally, a word about timing. As I said at the outset, it is important to evaluate and begin the path to implementing UI reforms in advance of the next recession. Whether the current administration is potentially interested in UI reform is not something I, or most other academics, likely have any special insight into. UI is, however, an important tool for cushioning workers affected by global economic trends, such as international trade and green technologies.[319] Those are, reportedly, constituencies important to the current executive. If not, experts outside the executive can still begin the task of agreeing on policies that might be appealing to the next administration.

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MIDDLE CLASS (2015), https://www.brookings.edu/research/wage-insurance-a-potentially-bipartisan-way-to-help-the-middle-class/.

318. Chetty, *supra* note 52, at 218–20; Martin Feldstein & Daniel Altman, *Unemployment Insurance Savings Accounts* 1–4 (Nat'l Bureau of Econ. Research, Working Paper No. 6860, 1998).

319. BLAUSTEIN ET AL., *supra* note 88, at 27–28.