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Meeting the Challenge of Household Earnings Instability

The U.S. labor market is a constantly churning sea of job creation and destruction. On average, 18 million new jobs appear each year, while 15 million jobs are lost.[1] The vitality of the labor market creates great opportunities for those who can navigate it successfully, but it also creates great risk and uncertainty for working families.

One result of a constantly changing labor market is that many American families experience substantial year-to-year instability in their earnings. While there is an ongoing debate whether that volatility has increased significantly in recent years, there is no question that it exists. About one in five workers experiences a decline in earnings of at least 25 percent from one year to the next, while one in nine workers sees a decline of 50 percent of more.[2]

Some of the volatility in earnings reflects family decisions to change jobs or to take time off from work to devote more time to family responsibilities. It also reflects involuntary loss of earnings as a consequence of illness or injury. Some of the volatility, however, is the outcome of the shifting job market as workers are displaced by slack demand, technological change, or competition from foreign producers.

Elements of the social safety net can help cushion the impact of a temporary decline in earnings because of a job loss, but there are few government programs to help those who suffer a permanent reduction in earnings. Unemployment Insurance (UI) is the main bulwark against temporary job loss, but the UI program has many gaps and is not designed to help with long-term job displacement or reduced earnings once a worker is reemployed. Programs explicitly designed to help displaced workers such as Trade Adjustment Assistance (TAA) are limited in scope and reach very few workers.

The federal income tax provides some assistance to families who experience a decline in earnings through the Earned Income Tax Credit (EITC), but that help is limited to those families whose earnings are low enough to qualify for the credit. Moreover, the EITC itself and other features of the tax system can exacerbate the consequences of earnings fluctuations by imposing higher taxes on families whose income fluctuates from year-to-year than on families with the same average earnings but whose earnings remain steady.

This paper explores the extent of earnings and employment instability faced by American families and possible ways to improve the social safety net and the federal tax code to help cushion the blow of job displacement and the complete or partial loss of earnings that too-often occur in today's economy.

DIMENSIONS OF THE PROBLEM

According to recent testimony by Congressional Budget Office (CBO) Director Peter Orszag, there is significant earnings volatility among American workers. CBO found that among those who were not in school, one in five workers ages 25 to 55 saw a one-year decrease in inflation-adjusted earnings of at least 25 percent, while one in nine saw a decrease of at least fifty percent. Other workers saw substantial increases in earnings. One in four workers saw a one-year increase in inflation-adjusted earnings of 25 percent while about one in seven saw an increase of at least 50 percent. While these results were for changes from 2001 to 2002, years in which job growth was slow, CBO found similar changes between 1997 and 1998 when employment was growing more rapidly.[3]

Workers without a high school degree tend to experience more earnings instability than workers with more schooling but there is little difference in earnings instability for workers in different age groups. There is some evidence that income instability is greater for lower-income families.[4]

Job Displacement

A key reason for family income instability is job turnover. Over the course of 2006, 4.9 million workers were hired each month on average, while another 4.5 million lost or quit their jobs.[5] Total job separations (quits, layoffs, and other separations) were about 3.4 percent of the total number of workers each month.

Some workers who quit or are displaced find new jobs right away, but others may take weeks or months to find new employment. The median duration of unemployment was about 8 weeks for those unemployed in January 2007 (half had been unemployed for less than 8 weeks, half for more). The average duration of unemployment, however, was over 16 weeks, meaning that workers unemployed for more than 8 weeks tended to have lengthy spells of unemployment. About 2.1 million unemployed workers (30 percent of the unemployed) were without a job for more than 14 weeks, while 1.1 million workers (16 percent of unemployed workers) were unemployed for more than 26 weeks.[6]

Some displaced workers are unable to find work and drop out of the labor force entirely. While the official number of unemployed workers was 7 million in January 2007, another 4.6 million workers wanted a job but had stopped looking for work and were therefore no longer counted as part of the labor force.[7]

Earnings Loss

A sizeable fraction of displaced workers who lose a full-time job return to work at less than full-time. About 10 percent of displaced full-time workers end up working part time, with the percentage higher during slack labor market periods such as the early 1980s and 1990s.[8] Even among those workers who are able to find new full-time employment, many who lose full-time jobs often earn considerably less at their next job. Among reemployed full-time workers, average earnings were 17 percent less than what they could have expected to earn had they remained on their previous job in 2001-2003, more than twice the average earnings loss for displaced workers in the late 1990s.[9]

HELPING FAMILIES MANAGE EARNINGS INSTABILITY

Whether because of technological change, plant closings, or foreign competition, job separation and earnings instability is a fact of life for many American workers. The troubling news is that more and more workers could be subject to this job churning as global competition increases. While it may prove impossible to turn back this tide of international competition, it is possible to improve support for displaced workers both as they search for new employment and after they become reemployed.

Some amount of job turnover is an inevitable part of a dynamic and flexible labor market that adjusts quickly to new economic opportunities and in turn contributes to strong economic growth and a rising standard of living. However, excessive job turnover and income instability can create worker anxieties and insecurities that impede those adjustments and ultimately slow economic growth. Reducing the harshest impacts of job dislocation and income instability is one critical step to reducing growth-inhibiting worker insecurity. In addition, policies that mitigate income losses and make it attractive for workers to pursue new training and job opportunities can facilitate adjustments to change and reduce the economic losses associated with job dislocations.

Unemployment Insurance

Unemployment Insurance (UI) is currently the main program to provide support to displaced workers. UI is designed to provide temporary assistance to workers who lose their jobs while they look for new employment. UI is a joint federal-state program. While the federal government administers the program and sets general guidelines, the states determine key features such as which workers are eligible for UI payments, and the amount and duration of benefits.

About 7.3 million workers received UI benefits at some time during 2006.[10] While many workers benefit from the program, there are issues regarding coverage, benefit amounts, and the duration of payments that undermine the effectiveness of the UI program as a cushion against family income shocks.

Coverage

UI is intended to cover workers who involuntarily lose their jobs. Workers entering or reentering the labor force or those who voluntarily leave their jobs without good cause are not eligible. The definition of good cause for voluntary separation varies from state to state, but may include reasons such as sexual harassment (in all states but six), anticipation of a plant closing, and, in a few states, certain personal reasons such as increased family care-giving responsibilities.[11]

Though nearly one in five workers is employed part time (35 or fewer hours of work per week), part-time workers are not covered in most states. Workers with low-wages or intermittent work histories also may not qualify. States require that workers meet minimum eligibility requirements with respect to earnings and hours of work in a base period. Most states continue to use a base period that includes the first four of the most recent five completed calendar quarters. This can deny benefits to workers who would meet the work history requirement if the base period included the most recently completed quarter. Finally, workers must be able to work and actively looking for full-time work while they are unemployed.

Many workers do not qualify for benefits as a consequence of those restrictions. In recent years only about 40 percent of unemployed workers receive UI payments, although about 80 percent of the unemployed who lost their last job did qualify for benefits.[12]

There are various proposals to improve UI coverage. These include standardizing the base period for determining eligibility to the past four quarters prior to a job loss, which would particularly help those with intermittent work histories; using hours of work rather than earnings to determine eligibility; allowing those who had been working part time before unemployment to remain eligible for benefits when looking for part-time work; broadening the definition of voluntary separation for good cause; and enabling reentrants who were eligible for UI at the time of job separation to receive benefits when they return to the labor force.[13]

Benefit Levels

Benefits in most states are set at half of a UI recipient's average weekly earnings up to a maximum amount. In January 2007, the maximum weekly amount ranged from a low of $210 in Mississippi to a high of $575 in Massachusetts.[14] Because of the cap, few state programs replace, on average, half of lost wages. While the percentage varies among states, on average UI benefits replace only about 36 percent of previous weekly earnings.[15]

Duration of Benefits

Most states limit the duration of benefits to 26 weeks, although extended benefits are automatically triggered when the state insured unemployment rate exceeds certain levels. Congress enacted the Temporary Extended Unemployment Compensation Act in 2002, which provided up to 13 weeks of benefits to workers who exhausted their regular UI benefits, but that program was not renewed when it expired in December 2003. Because benefits are only available for a fixed duration, many UI recipients exhaust their benefits—on average about one-third. The percent of recipients who exhausted benefits reached 44 percent in 2003.[16]

Trade Adjustment Assistance

Trade Adjustment Assistance (TAA) provides extended unemployment insurance benefits and job training to workers dislocated by trade. Under TAA, displaced workers can receive a trade readjustment allowance benefit once they exhaust regular or extended UI benefits, extending the total duration of benefits to 52 weeks. Workers in an approved training program can receive benefits for an additional 52 weeks after the basic TAA benefit expires.

Eligibility requirements to participate in TAA are strict. TAA is limited to workers who lose their jobs because of import competition. It is further limited to only manufacturing workers, excluding the large number of workers in technology and other services who are displaced by offshoring of jobs. In addition, workers who are laid off because their employers shifted production overseas may not qualify for TAA if the destination country has not entered into a free trade agreement with the United States.[17]

Because of restrictions on eligibility and lack of adequate funding TAA has helped only a limited number of workers. There were fewer than 55,000 new recipients of TAA trade readjustment benefits in 2006.[18]

Wage Insurance

Wage insurance would supplement the earnings of displaced workers who are forced to take new jobs at lower wages. Wage insurance would pay a worker who has been displaced and then hired at a new lower-paying job some portion of the difference between wages on the old and new job. Typically, payments would continue for a limited period of time and would be subject to an annual cap. Some proposals also include an earnings ceiling for eligibility based either on earnings at the old or new job. For example, a wage insurance proposal suggested by a number of analysts would pay 50 percent of lost earnings, cap total payments at $10,000 per year, and limit payments to two years.[19]

Wage insurance offers a number of potential benefits. First it can soften the blow of lost earnings for displaced workers. Wage insurance would take over where unemployment insurance ends once a displaced worker begins a new job. Second, the wage insurance supplement would enable some workers to take jobs that they might have otherwise forgone. Getting reemployed sooner can reduce the earnings loss a family faces after job displacement. Finally and perhaps most importantly, wage insurance would subsidize the hiring and training of workers who transition into new jobs or sectors. On-the-job training is often the most effective way workers can learn new skills, which in turn can lead to long-term wage gains.

Concerns about Wage Insurance

While wage insurance has advantages in encouraging workers to move more quickly to a new job, some have expressed concerns that such a program could hurt workers. First, critics of wage insurance argue that knowing that workers could get wage insurance could lead some employers to offer lower wages than they otherwise would have. Second, they argue that workers might take a poor quality job at a lower wage during the eligibility period even if waiting a little longer would lead to a better job at a higher wage. They are also concerned that workers may fail to take advantage of available job training opportunities in order to claim the subsidy as soon as possible. Third, opponents believe that, in an environment where there are limited resources available to benefit unemployed workers, some traditional protections could be undermined if wage insurance were seen as a replacement for unemployment insurance or job training programs. With appropriate administrative rules, however, potential adverse effects of a wage insurance program can be minimized. In conjunction with well-funded UI and job training programs, wage insurance offers potential additional protections for workers against the income instability caused by job loss.

Lessons from existing wage insurance programs or demonstrations

There are a few demonstration projects of wage insurance (and similar) programs from which to draw some lessons. During the late 1990s, Canada instituted a wage insurance demonstration project to test the effectiveness of a wage supplement for reemployed displaced workers. Workers were randomly assigned to either the supplement group, in which they received an earnings supplement in addition to standard UI benefits and services, or to the control group in which they only received standard UI benefits and services. The supplement was payable to those who were reemployed full time within a 26-week period, covered 75 percent of the earning difference for up to 2 years, and was capped at $250 a week.[20]

The demonstration project showed a moderate increase in employment among those in the supplement group but no impact on unemployment benefits taken. Reemployment rates were higher in the two months just before eligibility was to end. The authors who evaluated the project concluded that the wage insurance offered had little impact on worker's search behavior but did broaden the scope of the jobs they considered.[21]

In 2002, when Trade Adjustment Assistance was reauthorized, a small, temporary wage insurance program was added for older workers. Alternative Trade Adjustment Assistance (ATAA) is available to displaced workers 50 years or older, whose job losses are certified as having been caused by trade, and who are reemployed full-time within 26 weeks at a job with a lower wage. The benefit is 50 percent of the difference in earnings up to a total of $10,000 for two years, provided the new job pays less than $50,000 per year. In general, relatively few displaced workers have been declared eligible for TAA, and take-up rates for the older worker supplement have been even lower due to a variety of factors including poor dissemination of information about the program to eligible workers and the possibility that because the workers were over 50, very few employers were willing to hire them.[22]

In the mid to late 1980s three states experimented with programs in which unemployed workers were given one-time cash bonuses if they became reemployed within a certain period. While researchers found modest increases in employment rates among those eligible for the bonus, these experiments took place in tight labor markets.

CHANGING THE TAX SYSTEM

Families whose income fluctuates from year to year can pay more federal income tax than families with the same average income but whose income is steady. This is a result of the progressive structure of the federal income tax in which higher income is taxed at a higher marginal tax rate. For example, suppose a couple had taxable income of $60,000 in both 2006 and 2007, putting them near the top of the 15 percent tax bracket. (Taxable income excludes exemptions and deductions so the couple's total income would be much higher). The couple would pay combined total federal income taxes of $16,463 for the two years. By comparison, another couple with income of $40,000 in 2006 and $80,000 in 2007 would pay combined taxes of $18,093 – over $1,600 more. This would occur because most of the second couple's income in excess of $60,000 in 2007 would be taxed in the 25 percent bracket.

The effect of fluctuating income on federal taxes is modest for most families. The average tax change for an increase or decrease in income of 25 percent is only about 0.4 percent of after-tax income.[23] However, the effects are more pronounced for families with modest income who qualify for the earned income tax credit (EITC). Because of the high implicit tax rates in the way the credit phases in and phases out as income rises, families who qualify for the EITC are more likely to move between tax brackets if their income fluctuates from year to year.

Lower-income families can suffer another tax penalty from fluctuating incomes. All families can claim personal exemptions and a standard deduction (or itemized deductions if higher) when calculating the amount of tax they owe. As result, in 2007 a married couple with two children would not pay any tax on the first $24,300 of income. If a family's income drops below that exempt amount, any unused exemption is lost. Thus a lower-income family whose income fluctuates from year-to-year could pay more income tax than a family with the same average income who is able to use the entire exemption each year. There is no provision in the tax code for families to carry back or carry forward unused exemptions to years when its income is higher. Businesses, on the other hand, can carry back unused net operating expenses for up to two years or carry them forward for up to 20 years.

Income Averaging and Carry Back of Unused Deductions and Credits

A possible solution to the effect of fluctuating incomes on the taxes paid is to allow some type of income averaging. Income averaging was part of the federal tax system from 1964 through 1986 when it was eliminated. There were a number of reasons for eliminating income averaging including the overwhelming complexity of the way in which income averaging was implemented, and the thought that it was no longer needed because the 1986 tax reform eliminated many tax brackets and thus reduced the chances that fluctuating income would move families into different tax brackets.

For example, one proposal recommends targeted income averaging limited to the EITC. Families would be able to average income over two years when calculating the EITC, and would also be able to carry back unused exemptions for one year.[24]

In addition, income averaging also could benefit independent contractors, free-lancers, and others, including writers and artists, who are paid on a per-project basis, and whose earnings therefore often fluctuate from year to year.

CONCLUSION

Economic instability is a fact of life for many American families. With increasing globalization, rapidly changing technology, and shifting demand for goods and services, more workers may experience job displacement that can be temporary or more long-lasting. While the economy benefits from a dynamic and flexible labor market, excessive job turnover can increase family economic insecurity and ultimately impede economic growth.

Strengthening the social safety net to reduce the economic pressures from job churning and earnings instability is critical, but should be done in a way that not only provides the needed support but also allows workers to embrace new training and job opportunities. Wage insurance can be a welcome new thread in the safety net, but it is just as important that we strengthen existing programs such as unemployment insurance and trade adjustment assistance.

Ultimately, the American economy will thrive in the changing global environment as long as businesses provide jobs that offer workers real opportunities, and workers obtain the skills and training needed to fill those jobs.

ENDNOTES

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