TESTIMONY OF
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Mr. Chairman, Members of the Committee, thank you for the opportunity to testify before your committee. Your focus on income fluctuations is all too real for many American middle class families today and is likely to be a reality for many more in coming years. It is worth spending a minute on some of the likely economic drivers before turning to one of the promising policy responses.

A New Wave of Globalization

A new wave of globalization has reached our shores. Although the individual elements feel familiar, the combined contours are unprecedented – in scope, speed and scale.

Because China is successfully pursuing at a scale never seen before a growth strategy that is export-led and foreign direct investment fed, its rise is sending waves to the farthest reaches of the global economy. China is already deeply embedded in global manufacturing supply chains, confronting higher wage producers with the difficult choice of moving up the value chain or lowering costs.

India's concurrent economic emergence has complicated the challenge. While India is pursuing a growth strategy more reliant on domestic consumption and investment than China, nonetheless its success in exporting higher skilled "knowledge" services such as software programming has expanded the scope of globalization. Many Americans in white collar occupations are confronting the reality of low wage foreign competition for the first time.

The current episode of global integration dwarfs previous expansions: the entry of India and China into the global labor force amounts to an expansion of roughly 70 percent – concentrated at the lower end of the wage scale. Textbook economics would predict a squeeze on wage earners until capital and technology investments adjust. Indeed, the data suggests inequality is once again on the rise in many of the world's richer economies.

In the United States, profits are capturing a larger share of income and wages a lower share than at any time in the last 50 years. Moreover, economists David Autor, Larry Katz, and Melissa Kearney have pointed out that the gap between the middle and top of the U.S. wage distribution (between the 90th and 50th percentile) appears to be widening today, in contrast to earlier decades, where the focus was on the gap between the bottom and middle (between the 50th and 10th percentiles).

A Weak Safety Net

In the face of accelerated job losses in manufacturing and white-collar offshoring in services, an ever-broader pool of American workers is finding that the nation's safety net has more holes than netting.

Despite the fact that the U.S. labor market ranks second to none when it comes to job turnover, the nation's safety net for easing job transitions remains one of the weakest among the wealthy economies. Not only do U.S. unemployment benefits have a short duration, but America's heavy reliance on an employer-based system of insurance means that displaced workers face the prospect of losing health and pension benefits along with income. For permanently displaced workers, average earnings in the new job are 16 percent lower than earnings in their previous job, while displaced manufacturing workers generally face a 20 percent drop in earnings. The consequences of job loss are particularly damaging in import-competing industries, where displaced workers face longer spells of unemployment and greater permanent wage declines than do workers in other industries.

America's safety net is miserly in comparison with those of almost every other advanced economy. The main federally mandated unemployment insurance (UI) program contains so many restrictions that today only about 40 percent of all jobless workers receive benefits.

The last serious overhaul of the nation's employment safety net was in 1962, when President John F. Kennedy established the TAA program to compensate workers who suffer job loss as a result of trade liberalization. But workers have long found it difficult, time-consuming, and expensive to prove that they are entitled to extended unemployment benefits under the nation's Trade Adjustment Assistance (TAA) program.

In 2002 Congress overhauled and expanded TAA, adding a health care tax credit, doubling the training budget, and substantially raising budget outlays for income support. But the TAA program continues to disappoint. Participation has remained surprisingly low, thanks in part to confusing Department of Labor interpretations and practices that ultimately deny benefits to roughly three- quarters of workers who are certified as eligible for them. TAA has helped fewer than 75,000 new workers per year, while denying more than 40 percent of all employers' petitions. And remarkably, the Department of Labor has interpreted the TAA statute as excluding the growing number of services workers displaced by trade.

Despite its laudable goals, the TAA program has repeatedly failed to meet expectations. Between 2001 and 2004, an average of only 64 percent of participants found jobs while they participated in TAA. And earnings on the new job were more than 20 percent below those prior to displacement.

The Case for Wage Insurance

With workers more likely to face permanent displacement and experiencing average income declines of 16 percent when they are reemployed following displacement, the time has come for the federal government to augment existing programs by adopting a new insurance program that insures against wage loss, not just unemployment, for permanently displaced workers. [1] Wage insurance would smooth income fluctuations while encouraging displaced workers to broaden their employment search. It also defrays the cost to employers of hiring and providing on-the-job training to new employees from different sectors. On aggregate, wage insurance could lead to shorter spells of displacement and more efficient reskilling for workers.

A chief goal of wage insurance is to smooth the incomes of workers who suffer permanent displacement and declines in their earnings. Wage insurance is most likely to have overall positive economic benefits if it targets workers whose earnings would otherwise fall dramatically as forces outside their control devalue their skills. By replacing some of the lost earnings, wage insurance encourages more rapid reemployment; a Canadian pilot wage insurance program reduced unemployment durations by 4.4 percent on average.

Wage insurance can act as a subsidy of on-the-job training for the worker's new employer. Generalized retraining programs not only fail to guarantee a worker a job but also cost the worker the wages that he or she could earn by accepting new employment sooner. The retraining that a displaced worker receives on a new job provides new skills that contribute directly to his or her performance in the new job and is thus directly useful not only to the worker but also to the new employer.

Finally, evidence suggests that wage insurance encourages workers to consider different types of jobs and sectors of employment and, therefore, broadens the job search. This is particularly important for displaced workers whose firm-specific skills have declined in value.

Most programs designed to ease job transitions entail a trade-off between the degree of eligibility targeting and participation rates. While targeted programs should be more cost-effective in principle, targeting requires burdensome eligibility and compliance requirements that sharply lower participation rates and sometimes introduce stigma. The TAA experience argues strongly for a less targeted program implemented through an existing system with proven efficacy, such as the UI system or though the tax system as a refundable tax credit.

Moreover, if the goal is to provide some degree of insurance against extreme income fluctuations, wage loss insurance should be available to all permanently displaced workers, who have at least two years of tenure at the previous job. It might also make sense to restrict the program to workers displaced from full-time jobs and reemployed

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[1] Jeffrey Kling, Lori Kletzer, Robert Litan, and Howard Rosen have put forth a variety of proposals for wage insurance.

full-time, so as to avoid any possible incentive to reduce hours of work. Further, the compensation period would be limited to some initial period, perhaps 2 years, long enough to help strengthen the new employment relationship during the period when on-the-job-training is arguably most concentrated.

The wage loss replacement rate, the duration of benefits, and the annual cap on compensation determine the kinds of workers who would benefit most from the program. A high replacement rate combined with a low annual compensation cap would provide the greatest cushion to lower-income workers suffering steep losses in earnings, while a lower replacement rate combined with a high annual cap would tilt compensation toward higher income earners.

According to our estimates, a wage insurance program that replaces 50 percent of earnings losses for long tenure full-time displaced workers up to a maximum of $10,000 per year for up to two years would cost roughly $3.5 billion per year, using a conservative estimate of offsetting savings in other unemployment and training programs. On a per worker basis, this cost falls midway between the current unemployment and retraining benefits available under UI and Worker Investment Act (WIA) programs and the comprehensive cost of TAA benefits.

Under such a program, an average trade–displaced worker, who earned $37,382 in 2004 and was reemployed with a 26 percent loss rate at $27,662 would instead receive $33,522 for the first two years after reemployment, thus enabling them to smooth their income while becoming more valuable in the new job.

Of course, the costs can be substantially reduced by offering more modest benefits. For a high-unemployment year such as 2003, costs could range from a low of $1.6 billion for a one-year program with a 30 percent replacement rate and a $10,000 cap to a high of $7 billion for a two-year program with a 70 percent replacement rate and a $20,000 annual cap.

How do we think about the price tag? For a relatively robust program, the net cost of $3.5 billion per year amounts to an insurance premium of roughly $25 per worker per year. One simple way to finance the uncovered costs of wage insurance would be through a modest increase in the current federal unemployment tax (FUTA) with the incidence split between employers and employees.

Wage insurance could provide an important tool in a broader set of policies designed to help American middle class families insure against disruptive income fluctuations, while preserving the benefits of a dynamic economy. For the price of $25 per worker per year, the nation reaps economic benefits in the form of less income volatility and more rapid reemployment. Wage insurance could be an important policy tool to help make work pay following displacement; the intention is to augment the insurance available to middle class Americans facing the possibility of greater income volatility, to augment the programs current available – not to replace them.