

# BUSINESS REVIEW

Federal Reserve Bank of Philadelphia

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## Mass Transit Subsidies



The McFadden Act

&  
Unemployment  
Insurance Programs:  
A New Look  
for the Eighties?

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IS CHANGE IN THE MAKING?**

*Commentary by Edward G. Boehne*

**MASS TRANSIT SUBSIDIES:  
ARE THERE BETTER OPTIONS?**

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**UNEMPLOYMENT INSURANCE  
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A NEW LOOK FOR THE EIGHTIES?**

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. . . Recent studies suggest that current unemployment subsidies to both workers and employers may retard the achievement of full-employment goals.

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# COMMENTARY

## The McFadden Act: Is Change in the Making?

*By Edward G. Boehne, Senior Vice President,  
Federal Reserve Bank of Philadelphia*

A new wave of technology and competitive pressure has put the half-century-old McFadden Act on the defensive. Congress has asked for review of this statute, which says that national banks must comply with state branching standards, by year's end. And a recent court decision is prompting a broader legislative review of how thrifts and banks compete with each other.

Whether the McFadden Act is modified or left unchanged, the inevitable result of competition will be to alter the structure of banking for years to come. For underlying current consideration of the McFadden Act are basic forces which, history tells us, cannot be restrained by laws or artificial barriers.

### **TECHNOLOGY AND COMPETITION I**

Single-office banking dominated the American scene until the 1920s. Then came the automobile. As cities expanded and traffic

congestion in downtown areas increased, bankers found it more difficult to reach their customers. Moreover, the middle class was becoming affluent enough to make household accounts profitable. Innovative bankers began to search for ways to capitalize on the growing potential for profits through branching, especially citywide branching.

Federal law was construed to mean that national banks were limited to a single office. But state-chartered banks in some states operated under more liberal branching statutes. Thus pro-branching forces found flexibility by playing state regulations off against Federal regulations. The crack in the regulatory dike grew larger, much to the dismay of politically powerful unit bankers, as national banks converted to state charters.

The McFadden Act was passed in 1927 to restore some semblance of competitive equality to national and state-chartered banks in the new era of the automobile. Its

key provision allowed national banks to establish branches within the limits of the city or town where it was headquartered if state law permitted such branches to state banks. The Banking Act of 1933 liberalized this intracity limitation by allowing national banks to establish branches over the same geographical areas as those specified by the states for state-chartered banks, but interstate branching continued to be prohibited. Basically, there have been no further changes in Federal branching legislation since the 1930s.

## TECHNOLOGY AND COMPETITION II

History is repeating itself, but on a grander scale. Instead of the automobile broadening urban markets, it is an explosion of communication know-how that is broadening national and international markets. These broadened markets, now as before, are opening up new profit opportunities and placing intense pressures on established competitive relationships, as entrepreneurs inside and outside the traditional financial sector move imaginatively and quickly to find flexibility in a regulated environment.

Commercial banks have taken a number of initiatives. If hindered by the courts or one regulator, they often move to another regulator or to the state or Federal legislature. Bank holding companies, loan production offices, Edge Act subsidiaries, and chain banks have all exemplified this effort on the part of commercial banks to deal flexibly with restrictions on branching. Bank credit cards, too, have enabled banks to extend their markets beyond branching limits. And international branching has increased opportunities for foreign banks to reach new customers here and for American bankers to reach new customers abroad.

Moreover, and particularly disturbing to commercial bankers, there is increasing competition from those not bound by bankers' rules. Nonbank financial institutions, such as thrift institutions, mutual funds, and insurance companies, now have more assets

than commercial banks. Commercial bankers in restrictive branching states fear further erosion of their market shares if nationally chartered thrifts are allowed to branch statewide or across state lines within metropolitan areas. Such proposals are before the Federal Home Loan Bank Board. Congress, too, will soon be debating the competitive relationship of thrifts to banks in light of a court decision last spring which restricts the latitude of regulators to grant additional powers to financial institutions.\*

The challenge from nonfinancial competitors is even more formidable. Two firms, Sears and Montgomery Ward, have a greater dollar amount of consumer credit than do the 400 commercial banks in the entire Third Federal Reserve District. Of the 600 million credit cards outstanding nationally, 85 percent have been issued by companies other than banks. These companies are able to generate assets and open facilities without regard to the geographical restrictions faced by financial institutions. Many bankers feel that they are competing with one hand tied behind their backs.

## WHAT NEXT?

Although the competitive stage is bigger now and the technology is more complex, today's policy question is fundamentally the same as that faced by the framers of the McFadden Act: how to fashion a regulatory environment that balances the new competitive and technological realities against the traditions of maintaining the dual banking system and safeguarding small banks. To ignore competitive and technological changes would stifle innovation and make it more

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\* The U.S. Court of Appeals in Washington, D.C. ruled in April that the National Credit Union Administration, the Federal Home Loan Bank Board, and the Federal Reserve Board lacked the power, respectively, to authorize share drafts for credit unions, electronic terminals for savings and loan associations, and automatic transfers servicing for banks. The court stayed its order until January 1, 1980 to provide Congress time to respond.

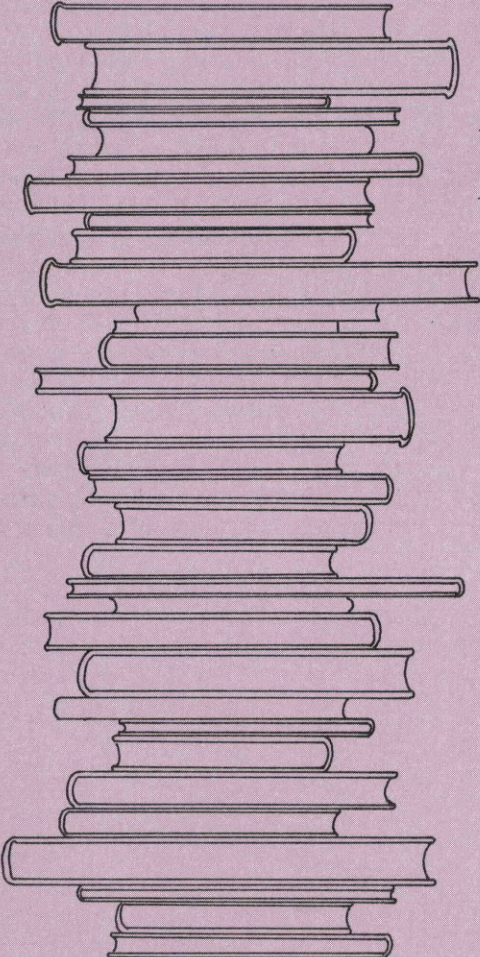
difficult for banks to serve expanding markets efficiently; to ignore traditional concerns would provoke an unproductive clash over established values.

The McFadden Act emerged slowly, and future change will likely emerge slowly as well. Some possibilities include: permitting interstate branching within metropolitan areas, perhaps limited initially to EFT terminals; permitting out-of-state bank holding companies to acquire failing banks; and permitting out-of-state banks to establish branches on a reciprocity basis. Further into the future, the possibilities include: statewide branching in all states and perhaps interstate branching outside metropolitan areas. Well down the road, the industry could develop a three-tiered structure, with several dozen multinational giants in the first tier, several hundred regional banks in the second, and a still larger number of small banks serving local markets in the third.

Well managed community banks have demonstrated that they can successfully

compete with branches of larger banks in the same way that specialty shops compete with department stores and quickstop grocery stores compete with supermarkets. Regulators can help foster a favorable climate for community banks by limiting the share of deposits large banks can have. For example, New Jersey, where statewide branching is legal, permits an individual bank to hold no more than 20 percent of statewide deposits.

Emotions run high when the branching issue surfaces. It was so during the debate that led to the McFadden Act in the 1920s; it will be so as changes in the McFadden Act are debated in the 1980s. If the past is any guide to the future, the new advance of technology and heightened competition will lead, as day follows night, to a further loosening of geographical limits on banking activity. The challenge is to facilitate adaptations that help bankers better serve the financial needs of their customers while maintaining sufficient continuity with traditional arrangements to avoid undue disruptions.



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# Mass Transit Subsidies: Are There Better Options?

By John Gruenstein\*

*Charlie handed in his dime at the Scollay Square Station,  
And he changed for Jamaica Plain.  
When he got there the conductor told him,  
"One more nickel!"*

*Charlie couldn't get off of that train!*

— The MTA (Metropolitan Transit Authority) Song  
by Bess Hawes and Jacquelyn Steiner,  
copyright 1948.

Like poor Charlie, doomed to ride forever neath the streets of Boston in a popular song of the 1960s, Philadelphians had to ante up another nickel to ride local buses, trolleys, and subways on January 1. Commuter rail fares are up as well. But although fares have continued to rise for the past fifteen years, they haven't risen enough to pay the costs of mass transit.

While most transit costs used to be covered by receipts from passengers, today the coins that jingle into fare boxes pay only about half the operating costs of getting from here to there and a far smaller portion of the capital costs. The rest comes from Federal, state,

and local governments, which spend vast and ever-increasing sums of tax money to stop the transit passenger from joining the passenger pigeon as an extinct species.

Thus transit subsidies and capital grants have become significant budget items for governments at all levels. Now, with dollar gasoline becoming a reality and long lines at filling stations fraying consumers' nerves, many observers are arguing that mass transit is an idea whose time has come—or come back. Together with environmentalists, the urban lobby, and others who are concerned with helping people who can't travel by auto, they are urging government to strengthen its commitment to mass transit, perhaps with money siphoned away from taxes on petroleum products. But such an expansion of subsidy programs could run headlong into another trend—the tax-revolt movement highlighted at the state and local level by California's Proposition 13 and at the Federal

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level by the Administration's efforts to trim the budget deficit.

Is government involvement on the current or an expanded scale justified? And if so, will giving subsidies to transit systems get the greatest return for the limited funding available? It may be that the carrot approach alone—transit subsidies—doesn't offer the most effective or the most equitable way to achieve the benefits linked to increased mass transit ridership. What is needed, some argue, is something of the stick approach—measures to reduce auto use directly.

### HOW GOVERNMENT INVOLVEMENT GREW

Government became involved with transit systems when a drastic loss of ridership coupled with rising expenses put many lines in grave financial difficulties. Since about 1920, people increasingly have chosen to make trips in private cars rather than on buses, trolleys, and trains. The result has been a decline in transit passenger trips from

about 14 billion per year in 1926 to under 6 billion per year in the early 1970s.<sup>1</sup>

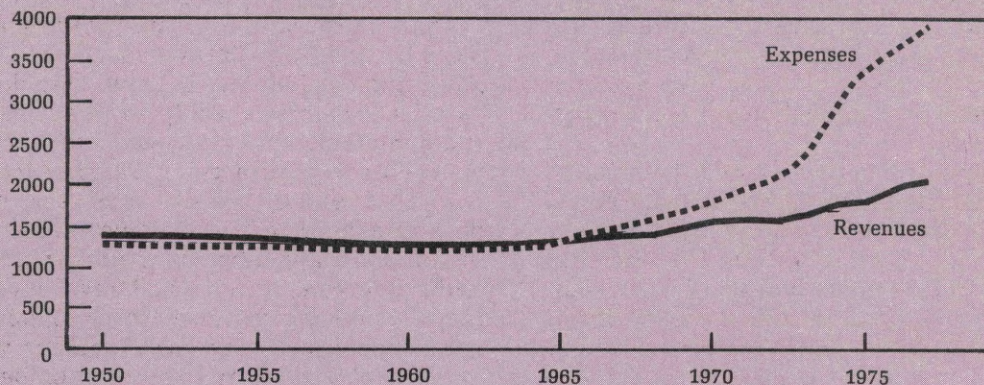
In the years immediately following World War II, falling ridership was offset somewhat by large fare increases, so that total passenger revenue dropped less sharply than total ridership. But expenses kept rising, first eroding profits and then creating large operating deficits (Figure 1). As the situation worsened, government stepped into the breach. Reacting to cries that mass transit was a necessary public service, local governments began to buy out many privately owned transit lines and to make up the deficits out of general revenue.<sup>2</sup>

<sup>1</sup>American Public Transit Association, 1977-1978 *Transit Fact Book*, Washington, D.C., 1978. These figures exclude commuter rail trips, charter trips, and trips paid for with transfers.

<sup>2</sup>Between 1948 and 1977, the percentage of operating revenues accounted for by publicly owned systems jumped from 25 to 90. See George M. Smerk, *Urban Mass Transportation* (Bloomington: Indiana University Press, 1974), p. 141.

**FIGURE 1**  
**SINCE THE EARLY 1960s TRANSIT OPERATING EXPENSES**  
**HAVE OUTSTRIPPED OPERATING REVENUES\***

Millions of Dollars



SOURCE: American Public Transit Association, 1977-1978 *Transit Fact Book*, Washington, D.C., 1978.

\* Excludes automated guideway transit, commuter railroad, and urban ferry boat.

Supporting transit was an expensive proposition for cities, even with state aid. So, in the 1950s, urban politicians, businessmen, and other interest groups began to lobby the Federal government to provide assistance. In the forefront of the effort were Philadelphia mayors Joseph Clark and Richardson Dilworth, Philadelphia Congressman William Green, and New Jersey Senator Harrison Williams. They argued that the Federal government had helped create the urban transit crisis by building the Interstate Highway System. This toll-free system, they claimed, financed as it was by gasoline tax revenues, greatly stimulated the use of automobiles and the suburbanization of people and jobs, thereby decreasing the demand for transit.

By the 1960s, this lobbying effort had begun to bear fruit. Federal legislation provided planning, demonstration, and capital grants and loans to mass transit, as well as mandating transit's inclusion along with highways in local transportation plans. In 1968 the Urban Mass Transportation Admin-

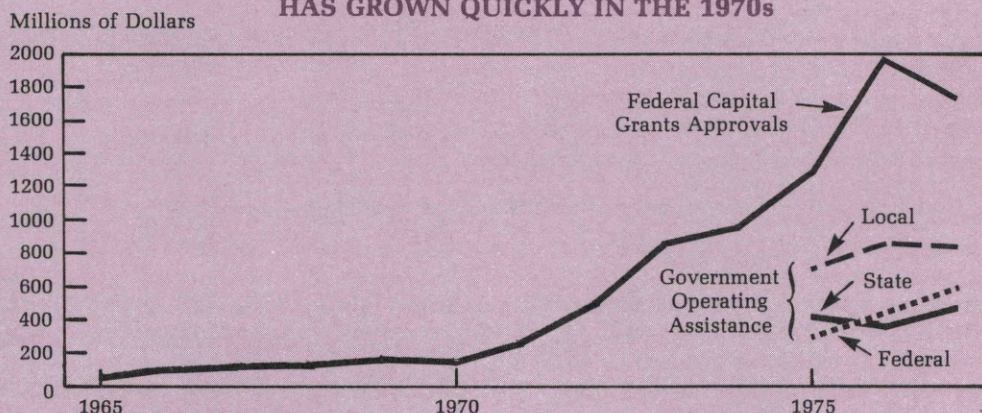
istration (UMTA) was established, pulling together transit programs that had been scattered among several agencies.

During the 1970s, Federal programs for mass transit have grown enormously. Total approvals for capital grants have increased more than tenfold since the beginning of the decade, from about \$130 million to over \$1.7 billion (Figure 2). Federal operating assistance has about doubled since it was approved in 1974, rising from \$300 million to over \$600 million. And the Surface Transportation Act of 1978 authorized outlays for all purposes of about \$3 billion dollars per year for the next five years.

So, as ridership has declined, government at all levels has rallied to support mass transit with growing infusions of tax money. Nationwide, total transit subsidies and grants from government reached about \$4 billion in 1977. But now major cutbacks are looming over the horizon (see TRANSIT IN THE DELAWARE VALLEY overleaf).

To those who want to wind down govern-

**FIGURE 2**  
**GOVERNMENT ASSISTANCE TO TRANSIT**  
**HAS GROWN QUICKLY IN THE 1970s**



SOURCE: American Public Transit Association, 1977-1978 Transit Fact Book, Washington, D.C., 1978.

\* Excludes assistance for commuter railroads. Operating assistance data prior to 1975 not available.

## TRANSIT IN THE DELAWARE VALLEY

Delaware Valley residents have long taken pride in their region's extensive mass transit network. But the same forces that cause problems for transit elsewhere are at work here, and the combined bus, subway, trolley, and train system run by the Southeastern Pennsylvania Transportation Authority (SEPTA) relies heavily on government subsidies for its capital improvements and day-to-day operations. And the prospects for continued subsidization are highly uncertain.

**Capital Improvements.** Between 1965 and the beginning of 1978, the Delaware Valley region received a total of \$624.6 million in capital grants for mass transit projects. Just under 75 percent of this total came from the Federal government, with the rest flowing from state and local treasuries. On the basis of past funding, the Delaware Valley Regional Planning Commission has projected that somewhere between \$1.2 and \$2.4 billion will be available for mass transit capital improvements between 1977 and 2000.\* But this depends on the willingness of governments to come up with these funds. In the past, even with high Federal matching ratios, nonavailability of state and local money has imposed a constraint on capital spending. And efforts to curb government budgets could well reduce the availability of state and local dollars still further.

**Operating Deficits.** Some SEPTA operations run on rails, others on streets, but they all run in the red. Passenger revenues will account for just under half of the \$296 million budget approved for 1979. Government funding of the rest has been forthcoming in the past, although often with great uncertainty until the last minute. But funding levels have not been large enough for adequate maintenance of equipment, and this shortfall, combined with numerous other problems, has led to poor quality service.

The squeeze almost certainly will tighten. In a February 1979 report on the state of SEPTA, the outgoing chairman of the board, John W. MacMurray, states that "SEPTA is at the end of a period of rapid increase in government subsidies."† He notes that although Federal funds authorized for SEPTA through 1982 under legislation passed in 1978 show year-to-year increases, amounts actually appropriated by Congress and requested by President Carter for future years show decreases. He concludes that "this uncertainty of the Federal funding for SEPTA's operating budget reflects the conflicting Federal interests of better support for mass transit and lower Federal spending."

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\*Delaware Valley Regional Planning Commission, *Capital Funding of Transportation in the Delaware Valley Region* (June 1978).

† John W. MacMurray, *Report on the State of SEPTA* (February 1979).

ment subsidy programs, it seems illogical and unfair that transit patrons should pay fares for round-trip rides that cover less than one-way costs. They argue for more reliance on user charges for government services where possible, which would mean higher fares and lower subsidies for mass transit. But others have argued that mass transportation benefits many members of society in addition to the riders themselves and that

these widely distributed pluses tip benefit-cost ratios in favor of subsidized transit.

### WHY SHOULD GOVERNMENT HELP PAY THE MASS TRANSIT BILL?

Both efficiency and equity considerations provide a basis for government subsidization of mass transit. 'Efficiency' refers to the overall economic welfare of society, 'equity' to the distribution of the goods and services

providing that welfare.<sup>3</sup>

**To Reduce Spillover Costs from Autos.** The strongest efficiency case for subsidizing transit comes from its ability to reduce costs from automobile usage which spill over onto society as a whole. Such costs are not fully taken into account by individual drivers, so additional inducements are needed to cut driving and stimulate transit use. Reductions of these auto costs count as transit benefits which accrue to everyone and therefore are efficiency gains.

The most important examples of these spillovers are air pollution, highway congestion, and energy use. Automobiles generally spew out more pollution per passenger mile than other forms of transportation.<sup>4</sup> Thus with every driver who can be induced to use transit, the level of air pollution will drop. Subsidization, leading to lower fares and better service on mass transit, can help effect such a shift, yielding benefits to society as a whole. Similarly for highway congestion: each car entering a congested highway slows everyone else down. So determined highway users should be willing to subsidize transit to

divert less dedicated drivers into buses, subways, trolleys, and trains.<sup>5</sup> Finally, mass transit uses less energy per passenger mile than automobile travel. So, if conserving energy is a national goal which is in everyone's interest, then again each person who can be induced to ride transit rather than drive provides a distinct social benefit.<sup>6</sup>

**To Promote Development.** Straddling both efficiency and equity is the argument that transit lines should be subsidized because they promote the economic and residential development of the areas they serve. It is true that such development can provide better jobs and housing opportunities to consumers, increase sales and reduce costs for business firms, and raise land prices for real estate owners in the vicinity of the line. But by the same token, the presence of transit lines in one area may put locales that lack transit at a relative disadvantage and thus cause them to suffer economic losses.

So for a net efficiency gain, any beneficial development near the line needs to more than balance losses elsewhere. The total change in land values resulting from a transit im-

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<sup>3</sup>If government action can increase the size of the economic pie available to everyone—if the aggregate benefits outweigh the aggregate costs—then such action is said to be justified on efficiency grounds. Equity considerations enter when the pieces of the pie are being handed out. If government alters the distribution of big and small pieces to benefit a group deemed particularly deserving of a larger share, its action is said to be justified on equity grounds. In principle, the distinction between efficiency and equity is a neat one. In practice, almost all programs contain elements of both. A program yielding overall net benefits will rarely distribute them equally to all members of society, so who gets what share—equity—must intrude upon consideration of programs which are efficient overall. Similarly, programs designed to redistribute income are never free of efficiency losses because of changes in incentives induced by taxes and subsidies.

<sup>4</sup>American Public Transit Association, 1977-1978 *Transit Fact Book*, pp. 42-43. All common pollutants (except for sulfur oxides) were generated at lower levels per passenger mile by urban buses and trains than by urban automobiles operating at both peak times and on average.

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<sup>5</sup>It might seem that the wider group affected by road and highway congestion is smaller than that affected by pollution, since everybody breathes but not everyone drives. But this neglects the effects of congestion on trucks carrying everything from food to furniture—products which are used by everyone, the prices of which include transportation charges. It should also be noted that passengers on congested trains and buses should be willing to pay something to other riders to get them into cars. This amount is almost certainly less than the amount drivers would pay to relieve highway congestion.

<sup>6</sup>This case is somewhat different from that for pollution and congestion because there is less reason to believe that the price of energy cannot reflect the social marginal cost of its production and therefore provide the appropriate market signals to would-be drivers or transit riders. The price of oil set by the OPEC cartel already is much higher than that cost and promotes a lower than optimal rate of use—even granted that oil is an exhaustible resource. The best argument for further attempts to reduce energy consumption, therefore, is that national security, which is a public good, is endangered by too great a reliance on uncertain foreign oil supplies.

provement, counting both gains and losses, provides a reasonable measure of such benefits. In some cases the change will be positive—for example, when a new line is built where none existed before. And where transit produces net positive development changes, it will provide legitimate grounds for subsidization, because the benefits accrue to nonriders.<sup>7</sup>

Since there are gainers and losers, equity must be addressed, too. Financing the improvement with a tax on the increase in land values and paying subsidies to those landowners who suffer losses would be fairest. But in reality, other taxes always have been used and subsidies have not been paid to losers. Thus, benefits generally accrue to some areas and groups at the expense of others. And so, even if development produces a net gain overall, the distribution of benefits remains a matter of concern.

In the past, suburban areas and the Southern and Western regions of the country have benefited from the construction of the Interstate Highway System while the older predominantly Northeastern and North Central cities have lost out. So Federal subsidies to mass transit which provide preferential aid to those cities may be justified as compensation for past inequities.

**To Help the Transportation Disadvantaged.** The poor, on average, are more likely than others to use some forms of mass transit—especially buses and inner city subways—because they usually have very limited access to automobiles. Thus subsidies to mass transit have the effect of redistributing income toward these people—a goal for which there is a clear mandate.

Some of the elderly and the handicapped also are transportation disadvantaged, because of low income or bodily infirmity. The Federal government recently has mandated greater accessibility to mass transit for these

people. To the extent that government mandates transit accessibility for them as being in the public interest, its additional costs should be paid out of general revenue rather than by user fares. Transit subsidies could help pay these costs.

Thus spillovers, development benefits, and help to the autoless seem to call for more mass transit and less automobile use. Other arguments for such a shift include technical difficulties in setting transit prices to promote efficiency (see *SUBSIDIES, TRANSIT PRICING, AND ECONOMIES OF SCALE*) and the contention by some that transit-oriented cities are more pleasing aesthetically than car-oriented ones. But there may be several plausible ways to bring this shift about, and the costs of these alternatives should be weighed along with the benefits. Transit subsidy and grant programs are the main mechanisms governments have used to stimulate transit and decrease auto use. How well they have worked, however, remains something of an open question.

### HAVE SUBSIDIES DONE THE JOB?

Transit subsidy programs undoubtedly have increased transit use over what free markets plus highway subsidies would have produced. But the costs of the transit subsidies may have exceeded their benefits in many cases. Both the size of net benefits and their distribution among different groups are relevant considerations in determining how well subsidies have achieved their goals.

Although many cost-benefit studies of individual projects and programs have been made, it is hard to generalize about program costs because different levels of government subsidize so many different programs. From the available evidence it appears that in many cases benefits have been smaller than anticipated and have not been achieved as efficiently as they might have been. And it appears also that the actual distribution of benefits and costs has not always been as desired on equity grounds.

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<sup>7</sup>The same argument applies to other transportation improvements like highways.

## SUBSIDIES, TRANSIT PRICING, AND ECONOMIES OF SCALE

The fact that some mass transit operations are characterized by economies of scale complicates the problem of setting the prices of transit services, and this also has a bearing on the use of tax subsidies to achieve economic efficiency. The average cost of carrying passengers on many forms of transit falls drastically as more and more people ride. This is especially true for modes which require expensive separate rights-of-way, like subways, since the capital cost of building the facilities is a large fixed cost which can be spread out over all the users of the system.

But if each extra rider reduces the average cost, then the cost of accommodating the extra rider must be less than the average cost. This extra or marginal cost is the real reflection of extra resource use and is consequently what the price should be set at to achieve efficiency. Unfortunately, at any level of demand where economies of scale are still present, this marginal-cost price is too low to cover total costs—that is, the operating costs plus the fixed costs of construction.

So the reason for charging the higher price (to avoid losing money) conflicts with the reason for charging the lower price (to avoid discouraging passengers willing to pay the extra costs of their ride). Government subsidies allowing transit companies to charge the lower, more efficient price are one solution.

Other solutions are possible. In particular, charging passengers a fixed fee per month or year plus a small marginal charge (even nothing at all) for each ride—like SEPTA's monthly commuter rail passes—could be fairer because it does not subsidize transit riders at the expense of all taxpayers—riders and nonriders alike. If such subsidies to riders are desirable on other grounds, however, then the ability to take advantage of economies of scale can reinforce the argument.\*

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\*Economies of scale throughout the normal range of use also lead to an industry organization which is naturally monopolistic. Big firms with lower unit costs drive out smaller ones. This has certainly been true in the transit industry and was an important reason for much of the earlier public regulation and, sometimes, the takeover of transit companies. But monopoly, *per se*, though stemming from the same cause as the pricing problems encountered in industries with economies of scale, is obviously not an argument for public subsidization of transit.

**Benefits Have Been Smaller Than Anticipated.** . . The main reason that the benefits from subsidies may be smaller than hoped is that lower transit fares and service improvements have been unable to break America's love affair with the automobile. Transit ridership increases and corresponding decreases in auto use have been relatively small compared to the amount expended to achieve

them. Thus many of the projected benefits of transit use, which hinge on reducing the use of cars, have failed to materialize on the scale desired.<sup>8</sup>

Why do lower transit prices have so small an effect? One answer may be the steady rise in incomes, which has led to more widespread automobile ownership, a more dispersed residential pattern, and a higher val-

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And some transit improvements largely shift people from other transit lines rather than cars. Andrew Hamer, in *The Selling of Rapid Rail Transit* (Lexington: D. C. Heath and Co., 1976), cites 1974 ridership figures for BART indicating that over 50 percent of the daily patrons had been diverted from other transit modes while less than one-third had formerly made their trips by auto. The cost per driver diverted to transit is therefore quite high.

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<sup>8</sup>A number of studies have demonstrated the low responsiveness of transit ridership to changes in prices. For example, pioneering investigation of Chicago commuters in the 1960s indicated that even free transit rides would have diverted only 13 percent of all auto commuters to public transportation. Leon N. Moses and Harold F. Williamson, Jr., "Value of Time, Choice of Mode, and the Subsidy Issue in Urban Transportation," *Journal of Political Economy*, June 1963, pp. 247-264.

uing of privacy, time, and convenience. Another is the low out-of-pocket cost for car trips compared to the much larger but much less visible sunk cost of automobile depreciation, licensing, insurance, and maintenance. Higher gasoline prices and spot shortages have helped transit subsidies reverse the ridership downtrend somewhat, but how large or lasting their impact will be remains to be seen.

### **... And Costs May Have Been Too High.**

The usual criticism of government programs—that they are too costly—can and has been leveled at mass transit subsidies. It is not clear that these programs are any worse or better than others. But in at least one respect—project evaluation—the procedures of the Federal Urban Mass Transit Administration and some other government agencies involved with transit seem to have been deficient. Cost-benefit calculations to decide among projects were not required in the early years of the Federal capital grants program. And despite the fact that extensive cost-benefit studies are required now, some critics maintain that they could be improved in many ways.

Some argue, for example, that expensive new subway systems like Washington's METRO and Atlanta's MARTA are being built without proper consideration of cheaper alternatives. Their contention is that the cost-benefit studies cited in support of subways have often given short shrift to well designed bus systems using reserved highway lanes for express buses, priority curb lanes for buses on downtown streets, and

other innovative features.<sup>9</sup> Although many transit professionals have labeled such bus systems unworkable and therefore unworthy of consideration in cost-benefit calculations, others claim they can meet the same needs as subways at a fraction of the cost.

### **Equity Sometimes Has Been Furthered.**

In judging whether equity has been furthered by transit subsidies, the distribution among various people of both the benefits and the taxes used to pay for them must be considered.<sup>10</sup> Some transit programs almost certainly accomplish a redistribution of income toward the poor or aged. In Pennsylvania, for example, lottery receipts are used to reduce fares for elderly transit riders. And in Atlanta, a sales tax is used to reduce fares for everyone. The tax in Atlanta's case is regressive—people with lower incomes pay a higher percentage of their income in taxes than do the more affluent. But since the percentage of lower income people who use transit is relatively large, overall this group gets more back in benefits than it contributes in taxes.<sup>11</sup>

But other programs may make the distribution of income more uneven, despite the heavier taxes paid by those relatively affluent people who benefit most. Much criticism, for example, has been leveled at the use of tax money to subsidize subway and commuter rail lines on the grounds that they serve mainly to bring relatively affluent commuters into downtown areas. Such sub-

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<sup>9</sup>The bus-versus-subway debate is hard to settle because present bus systems usually fall far short of the potential performance touted by bus advocates. Some comparisons of express bus systems with subways have been made, but the results are inconclusive. The seminal work in the bus-versus-subway debate is John Meyer, John Kain, and Martin Wohl, *The Urban Transportation Problem* (Cambridge: Harvard University Press, 1965). See also Hamer, *The Selling of Rapid Rail Transit*.

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<sup>10</sup>Two economists at the Brookings Institution, Joseph A. Pechman and Benjamin Okner, have calculated that the total burden of all taxes combined—local, state, and Federal—probably is about proportional to income for the great majority of people. So it is not necessary for those at the lower end of the income scale to get more benefits than those at higher levels for the distribution of benefits to be in the direction of greater equity, only for them to get more in proportion to their incomes.

<sup>11</sup>For a description of the Atlanta program see John W. Bates, "Using Sales Tax To Support Low-Fare Pricing of Transit Services in Atlanta," in Transportation Research Board, Special Report 181, *Urban Transportation Economics*. (Washington, D.C.: National Academy of Science, 1978).

sidies, it is argued, provide little direct benefit to the poor and elderly in cities, because outlying jobs, shopping, and recreational facilities are seldom within walking distance of terminals in the relatively spread-out suburbs. Even the indirect benefit that accrues to these groups from downtown economic development, which provides jobs and thus taxes to pay for social services, may not completely offset the lack of direct benefit.

So some transit subsidy programs probably do work in the direction of greater equity while some probably do not. Equity gains and losses should be counted in decisions to keep, expand, or cut programs. But consideration should be given also to alternative means of achieving the same goals.

Typically, programs which subsidize certain goods or services rather than certain people suffer from two distinct defects as primary vehicles of income distribution. The first is that *all* purchasers—in this case all transit riders—receive the benefits of the subsidy, whether or not they belong to the target group. The second defect is that the intended recipients of the benefit might prefer the cash value of the subsidy to the subsidy in kind. In the case of transit, greater equity might be achieved by providing transportation vouchers to target groups than by overall subsidies. And if making the poor better off, rather than improving the transportation system, is the principal goal, direct income transfers through welfare or a negative income tax might be more efficient than a traditional subsidy.<sup>12</sup>

Summing up, transit subsidies have achieved some goals and failed to achieve others. Looking behind the goals shows that

many of the conditions that transit subsidies are intended to rectify stem from too much auto use rather than too little transit use. But if automobile use is the root cause of this situation, programs with direct impacts on auto transportation probably are required for a successful transportation policy.

### A DIFFERENT APPROACH

Because both autos and transit are part of the urban transportation problem as well as its solution, what is needed is a more fully integrated approach to urban transportation. Along these lines there is currently strong interest at the Federal level in coordinating transit and highway programs. While fraught with political obstacles, effective coordination could help trim the size of the subsidies going to both transit and highways, without cuts in service. With this in mind, the Secretary of Transportation has proposed merging the Urban Mass Transportation Administration and the Federal Highway Administration. And within UMTA itself, low-capital alternatives to transit subsidies, encompassing automobile restrictions and pricing schemes as well as operational changes in transit modes, are seen as promising a way to hold down costs while achieving better transportation. Proper pricing of roads and better regulation of autos could be the key to a much better use of resources and a much smaller commitment of funds to the entire public transportation sector—roads and transit.

The urban transportation problem may be likened to a very stubborn donkey. Transit subsidies make a juicy carrot to dangle in its face; but, unfortunately, a stick seems to be necessary as well to hasten the pace. The stick could take the form of pricing for streets and parking that conveys more fully to drivers the true scarcity of the resources they are using, along with restriction or regulation of automobile use where pricing appears too costly or otherwise inappropriate.

**Road Pricing.** Drivers of automobiles are

<sup>12</sup>Most economists favor pure transfers to promote equity. Some exceptions to the rule are Lester C. Thurow, "Cash Versus In-Kind Transfers," *American Economic Review*, May 1974, pp. 190-195, and George A. Akerlof, "The Economics of 'Tagging' as applied to the Optimal Income Tax, Welfare Programs, and Manpower Planning," *American Economic Review*, March 1978, pp. 8-19.

more likely to respond to the extra costs their actions impose on the people on the other side of the windshield if these costs are forced upon them in the form of higher prices for auto use. Charges for driving in congested and polluted areas and at peak times of day would be particularly effective. Although pricing schemes to promote more rational use of roads and highways have been advocated for decades, they have almost never been put into practice. Two commonly proposed methods are the use of automatic vehicle meters and supplementary licensing to enter or traverse certain zones.

Automatic vehicle monitoring (AVM) systems offer a way to move the toll collector out of the toll booth and into the car with the driver. Such devices are being used in New York Port Authority buses, but only to collect the usual bridge and tunnel tolls, not for congestion and peak-time pricing. The technology and politics of implementing AVMs on a wide scale might prove to be severe.

An alternative way to charge drivers for adding to congestion is to levy a supplementary license fee for peak travel in the central business district. A quite successful plan of this type has been in effect in Singapore since 1975 (see *THE ROAD TO SINGAPORE*). UMTA has been looking for a U.S. city interested in trying such a plan, but up to now there have been no takers.

**Increased Parking Charges.** A different type of pricing scheme is to increase parking charges for downtown commuters. Besides reflecting the cost of parking-lot land, parking surcharges would indirectly capture the cost of using the urban roads to get to the parking space. A prime example of a city which used to operate in just the opposite fashion is Washington, D.C. Many government employees had free parking spaces in the heart of downtown until the present Administration instituted a charge for parking in the interest of saving energy.

**Road Management.** When administrative

## THE ROAD TO SINGAPORE

In 1975, Singapore became the first city in the world to restrict peak-hour downtown automobile traffic through the use of supplementary licenses. For \$26 (U.S.) per month, drivers can purchase special permits which must be displayed for morning peak-time entry into the most congested part of the city—a central area covering about twelve square miles. The 22 entry points to this area are monitored by police, who record the regular license numbers of violators and write tickets which are issued by mail.

These licenses are the key to the overall anticongestion plan. Two additional elements, also implemented in 1975, are the doubling of parking fees at public lots in the restricted area and the inauguration of a park-and-ride system. The latter consists of downtown shuttle bus service from about 10,000 parking spaces around the periphery of the restricted zone, carrying a total user charge of \$13 per month for parking and riding.

The program has been extremely successful. Congestion has been reduced drastically for all travelers—bus passengers, pedestrians, and the remaining drivers. The peak flow of cars into the downtown area has decreased by about 40 percent. Reductions in travel time on regular city buses have run about 25 to 30 percent during peak hours.

The program has worked well in other ways, too. Downtown business evidently has not been hurt. Air pollution has been cut. And program revenues have far exceeded administrative and enforcement costs. Overall, the costs of the system appear to be smaller than the benefits.\*

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\*A description of the Singapore experience may be found in Peter L. Watson and Edward P. Holland, "Congestion Pricing: The Example of Singapore," in Transportation Research Board, Special Report 181, *Urban Transportation Economics* (Washington, D.C.: National Academy of Sciences, 1978).

costs seem too high for road pricing methods or the public refuses to accept them, other types of restrictions to achieve the more efficient use of roads could be employed. Metering of ramps onto highway interchanges to improve traffic flow has been implemented in some areas. Special priority lanes for buses, van pools, and car pools also have been tried, although they have not always been accepted by drivers. Outright bans on parking or driving in certain areas, especially downtowns, could be a second-best alternative to charging autos a premium to drive there.

Road pricing and management are useful for achieving greater efficiency, but what about equity? Cutting transit subsidies without making offsetting changes would be a move away from helping the transportation disadvantaged. But if transit use is increased by restrictions on autos so that it is closer to a socially optimal level, economies of scale in transit could help lower the incremental cost per rider. This would help those who use transit more, like the poor and elderly. Furthermore, subsidies wouldn't have to be cut, even if taxes were lowered, if some or all revenues derived from highway pricing were diverted to transit. Finally, even if the end result were higher fares than before, transportation vouchers could be used to offset losses to the poor if society deemed it desirable to make up these losses. Although the funds for such vouchers would come out of tax revenues, this method of promoting equity

probably would allow better targeting of subsidies to people with lower incomes.

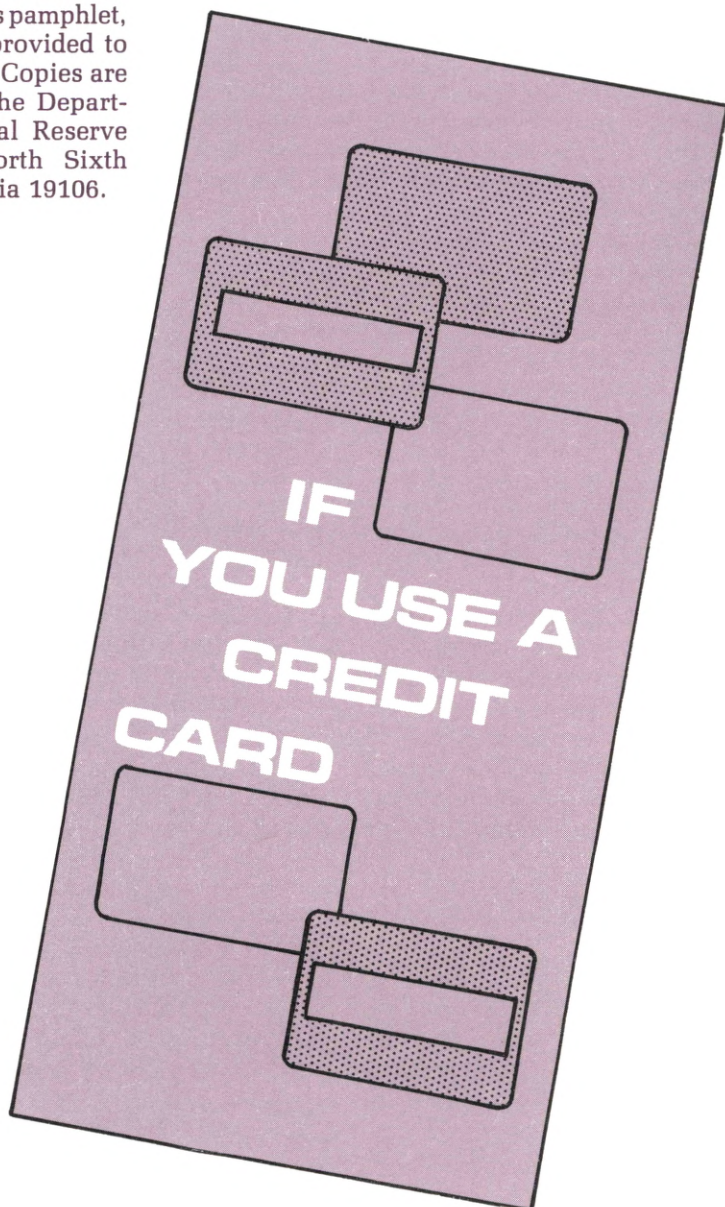
### PROSPECTS FOR THE FUTURE

While there are sound reasons for government involvement in mass transit, past programs seem to have been less than optimal. Some subsidies are desirable, but for full impact they need to be coordinated with road pricing and other restrictions on automobile use. Thus a rethinking of goals and an effort to get more productivity from the transportation dollar might be the best way to reconcile a desire to cut taxes with a reluctance to give up social benefits. And this rethinking is especially important now in the light of recent increases in energy prices.

Given the current political urge toward less government rather than more, it might seem that this is an unlikely time to bring in more regulations and fees for automobiles. Resistance from drivers is to be expected, since they will bear the costs directly but may be dubious about the benefits. Still, to the extent that roads and parking facilities have been subsidized by government actions in the past, a withdrawal of the implicit subsidies going to auto travel would be both efficient and equitable. And if road fees were used to help finance transit (where justified by public benefits), the quid pro quo of reducing taxes by cutting the amount of general revenue that goes to transit subsidies could be the key to acceptance.

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# Unemployment Insurance Programs: A New Look for the Eighties?

*By Robert J. Rossana\**

Public interest in employment policy has tended to focus on limiting overall unemployment to a certain percentage of the labor force. The Full Employment and Balanced Growth (Humphrey-Hawkins) Act of 1978, for example, requires that policymakers attempt to achieve an unemployment rate of 4 percent by 1983. Clearly, reducing unemployment is high on the policy agenda. There is some evidence, however, that current insurance programs which provide compensation to the unemployed may work against achievement of precise statistical goals.

The reason seems to be that, with the advent and growth of job insurance, temporary layoffs have become much more common. Workers have come to expect them and to regard unemployment benefits as a part of

the income package they get when they choose among places to work. And employers have become more inclined to lay off workers during periods of low demand than to go through the cycle of firing, hiring, and training as demand fluctuates—especially since employers don't pay the whole insurance cost.

Thus unemployment insurance programs, while easing the hardship of job loss for many workers, may have contributed, quite unintendedly, to raising the level of unemployment in the economy at large. As policymakers struggle to get within the overall unemployment goals set by Humphrey-Hawkins for the decade ahead, they may need to restructure these programs to reduce their unemployment side effects while still providing for their primary function—easing the burden of job loss.

## **HELPING THE UNEMPLOYED**

Programs designed to aid the unemployed

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were established in some parts of Europe as early as the eighteenth century. But it wasn't until the early part of this century that unemployment compensation programs became a permanent part of the economic landscape.

The American experience with these programs dates from the 1930s, when the national economy was in the throes of a depression and unemployment was at an all-time high. With the passage of the Social Security Act of 1935, the U.S. made its first large-scale attempt at compensating people who had lost their jobs.

From the beginning, legislators thought that compensation programs should be run jointly by Federal and state governments to ensure that they would be flexible enough to meet differing needs in various regions of the country. The result has been that, with each state largely free to develop its own program, the details of programs have differed from state to state, with rules for eligibility, payments, and the like varying greatly. But despite their diversity, these programs have one feature in common—their strong growth record.

One way to measure their growth is to look at the increase in the range of workers they have come to include. At first, job losers in agriculture and government were excluded from compensation programs, as were employees of firms which hired fewer than 20 people. As experience accumulated, policymakers extended the coverage of the system to include most members of these groups. Figure 1 gives some idea of how inclusive unemployment compensation has become. This figure, which represents the situation up to 1973, shows that the percentage of paid employment covered by state programs has risen over time in a number of industries. With more recent changes in law, it is likely that over 90 percent of potentially coverable employees now are eligible to receive insurance benefits.

Another way to get a feel for the growth of these programs is to look at the duration and

dollar value of their benefits. Most states now authorize benefits for a period of up to 26 weeks, with extensions to 39 weeks in times of high unemployment. Congress has the power to authorize further extensions to 52 or even 65 weeks for certain areas during recessions or other periods of persistent high unemployment. In 1976, the nationwide average for duration of benefit payments was just under 15 weeks, with state averages ranging from slightly under 10 weeks to slightly over 20 weeks.

The average weekly benefit paid out, considering all groups of recipients, currently stands at about \$82 nationwide, ranging from a low of about \$60 in some states to a high of over \$100 in the District of Columbia. And considerably higher levels of income support are available in some places, up to a high of \$174 weekly in Connecticut for a worker with dependents. Over the quarter century 1950-74, average benefits paid per week rose further (51 percent) than average weekly earnings (42 percent) in real terms.

**FIGURE 1**

**PERCENTAGE OF EMPLOYMENT  
COVERED BY INSURANCE  
HAS RISEN SHARPLY**

Industry	Percentage Covered		
	1939	1960	1973
Agriculture	0	8.1	25.7
Manufacturing	94.7	99.2	100.0
Services	49.0	54.5	88.8
State & Local Government	0	5.8	25.2

SOURCE: Adapted from Daniel S. Hamermesh, "Jobless Pay and the Economy," The Johns Hopkins University Press, 1977.

In total, the benefits paid out by the states rose from a level of \$1.2 billion in 1939 to \$10.5 billion in 1975 (in 1967 dollars). At roughly 13 percent of all government transfer payments, jobless benefits were unusually high in the 1974-75 recession, when unemployment hit a postwar peak. But even adjusting for business cycle fluctuations, the numbers show that jobless pay programs have become a major activity of government.

While people may qualify for compensation for a variety of reasons, those on temporary layoff—still tied to firms but not currently working—have been among the chief intended beneficiaries of compensation programs; and they continue to make up a sizable percentage of the unemployed. Thus it's especially useful to look at how current programs have affected their behavior and that of their employers.

### WHAT THE NUMBERS SAY

Many people immediately think of layoffs when they hear the latest figures on unemployment. In fact, total unemployment includes individuals who are unemployed for reasons quite unrelated to layoff.<sup>1</sup> But the Labor Department's Bureau of Labor Statistics does publish other figures that apply just to those on layoff.

**The Current Population Survey (CPS).** The CPS is the source for the official unemployment rate estimates issued by the BLS. It is a monthly survey of a very large number of households and gives detailed information on temporary layoffs.

Figure 2 presents data from this survey for March 1974—a month well into the last recession's drop in demand. The data refer to men aged 25-64. Men in this age bracket, at least those in the upper end of it, are not likely to be unemployed for reasons other than layoff. These men typically feel more or less permanently attached to their employers

because they are the primary breadwinners in their families, because they have vested pension rights, or because they find it difficult to change jobs by reason of age.

The CPS data are revealing. During the sample month, the national unemployment rate was 5.3 percent and was rising because the economy was in a business downturn. Over 40 percent of all male job losers in the 25-64 age bracket lost their jobs because of temporary layoffs—about half of total unemployment. Further, the duration of unemployment was relatively short for these men, averaging 3.6 weeks for those on fixed-duration layoff (30 days or less) and 11.4 weeks for those on indefinite-duration layoff (over 30 days). Finally, most laid-off workers apparently expected to be recalled by their employers, since very few were searching for new jobs in the week prior to the survey. Only 15 percent of those on indefinite-duration layoff were job searching. An even smaller percentage of those on

**FIGURE 2**

### FOUR OUT OF TEN JOB LOSERS ARE LAID OFF

	Job Losers on Layoff (Percent)		
	Total	Fixed Duration	Indefinite Duration
<b>Men Aged 25 - 64</b>			
Percent of All Job Losers	40.4	13.0	27.4
Percent of Job Losers Who Search	11.9	4.6	15.4
Average Duration in Weeks	8.9	3.6	11.4

SOURCE: Adapted from Feldstein. Figures are as of March 1974.

<sup>1</sup>A host of reasons can be advanced. People may quit, for example, to look for a better job; or they may re-enter the labor force after caring for a family.

fixed-duration layoff were searching.<sup>2</sup>

Thus the CPS data suggest that, during periods of reduced demand, a large part of national unemployment is made up of those on temporary layoff, temporary layoff unemployment is of rather short duration, and people on temporary layoff tend not to look for other jobs.

### HOW PEOPLE—AND FIRMS—BEHAVE

Economists assume that people are always maximizing something. Firms are assumed to maximize profits; workers are assumed to maximize their own welfare. In short, it's expected that workers and firms will respond to economic incentives. These assumptions provide the key to linking unemployment compensation to the job-search and layoff decisions workers and firms make. How do workers change their behavior because of unemployment compensation? And how do firms respond to the fact that, because of the way unemployment programs are financed, they don't bear the full cost of compensating the people they lay off? A useful approach for investigating these questions, which takes account of both worker and firm behavior, has been presented by Martin Feldstein (see SUGGESTED READINGS).

**The Employee Viewpoint: Maximize Welfare.** According to Feldstein, American workers are a pretty savvy lot, well aware of the income alternatives they face. They know that they pay taxes on ordinary income. They know that the unemployment compensation they receive when laid off, though it may be lower than gross wages, isn't taxed.

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<sup>2</sup>These numbers represent the period out of work at the time the survey is taken. They don't indicate what happens after the survey—whether workers continue on layoff or are recalled. Thus they may not give a completely accurate picture of layoff duration.

Classifying layoffs by duration is somewhat arbitrary, but it does give us a feel for how likely it is that a worker actually will be recalled. Also, those on indefinite layoff themselves probably attach a lower probability to recall than those on fixed-duration layoff.

The difference between the positive tax rate on wages and the zero tax rate on compensation is, technically, a subsidy (see Appendix).

In principle, workers also know something about the layoff decisions of the firms they might work for. A person considering employment at General Motors presumably can gather accurate information about past layoff decisions at GM and other potential employers. Having gathered this information, the worker can choose a package that will make him as well off as possible. This package may include both time on the job at one after-tax income level (wages minus taxes) and time off at another level (unemployment benefits).

Workers who anticipate layoffs have two choices open to them when they finally are laid off. They may search for another position, or they may engage in nonmarket activities. Those who choose to search presumably will be looking for a better package and so will not go back to work unless they find one. Those who don't bother to search remain inactive even though they might have been able to find another job. Both of these options are made more attractive than taking the first opening that comes along because unemployment insurance replaces a large portion of net wage income—from one-third to two-thirds, by most estimates.<sup>3</sup> So unemployment programs affect the behavior of workers whether or not they search.

**The Company Viewpoint: Maximize Profits.** Firms are presumed to be interested in profits. To be profitable, they must take account of, among other things, all their labor costs, including direct costs such as wages and benefits and indirect costs such as recruiting, training, and paying taxes to the unemployment insurance fund.

Faced with a decline in demand for its products, a firm may reduce either hours or

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<sup>3</sup>See, for example, Feldstein, "Unemployment Compensation: Adverse Incentives and Distributional Anomalies."

employment or both in order to cut its wage bill. Reducing employment has a cost attached to it, since the firm pays unemployment insurance taxes. But since firms typically are not taxed for the full amount paid out in benefits to the people they furlough, layoffs are cheaper than they might be. Thus firms receive a subsidy for their layoff behavior.

Most states levy unemployment insurance taxes on all employers at a basic rate and use a formula to determine how much more a firm will have to pay over and above the minimum up to a certain maximum rate. The idea behind this approach is that percentage increments should be based on a firm's layoff history in the insurance program. Thus firms that have made more layoffs than average in the past are expected to pay taxes above the basic rate. Pennsylvania, for example, has a formula which compares benefits paid over several years to average payroll over the same period. But state formulae typically do not place the whole burden on the employer who makes the layoffs, because any payouts that exceed the employer's maximum liability will be underwritten out of the fund, which comes from other employers' contributions and from other sources. Also, because of lags in recomputing the experience record, a firm that exceeds its historical layoff levels will have a grace period before it begins paying even the formula rate that corresponds to its current layoff behavior. The upshot is that many firms do not pay the full cost of layoffs.

Further, if a firm's management knows either that employees on layoff will not seek alternative employment or that, even though job seeking, they are likely to be available for recall, then the firm can recall these workers without having to pay for recruiting and training as it would if it hired new employees. In this way, the firm avoids some of the costs attached to increasing its labor force when demand is restored to its old, higher level.

In sum, the effects of the subsidy make layoffs cheaper than they would otherwise

be, providing an incentive for businesses to furlough more workers and, if necessary, to increase the number of hours worked by remaining employees during periods of reduced demand.

**For Example.** These effects on worker and employer behavior can be highlighted by imagining how the economy would look without the unemployment subsidy.

A potential employee considering employment with two firms would be concerned not only with the wage he could earn but also with the other characteristics of the job, such as fringe benefits, advancement potential, and working environment. Additionally, the riskiness of the job—that is, the probability of layoff—would be an issue. Suppose that these two firms were identical in every way except that one firm had made more layoffs in the past. In the absence of the unemployment subsidy and if this worker were at all risk averse, then the firm that had made more layoffs probably would have to offer a higher wage rate. It would have to do this in order to induce people to accept employment in a more uncertain job rather than a safer one. That is, a risk premium would arise in this labor market.

Now put back the unemployment subsidy. The riskier firm no longer has to offer as high a wage since workers can look forward to receiving unemployment benefits while on layoff: potential employees are more likely to accept employment with this firm because they know that they can count on unemployment benefits.

The example clearly shows that firms with relatively volatile employment policies are being subsidized to the extent that the wage rate they can offer is lower than it would be if there were no unemployment insurance. Since the unemployment subsidy to employers distorts the wage rates which would prevail without the subsidy, compensation programs, as currently constituted, lead to an inefficient allocation of resources in the economy, and society gets less output from its resources.

There is another way to bring out the inefficiency occasioned by the unemployment subsidy. When employees are laid-off, neither those who spend all their time searching nor those who simply take time off at a reduced income level are producing anything. In this framework, laid-off workers are, from society's viewpoint, searching too much or taking too much time off. Society gives up the output which these workers otherwise could produce. Thus, because of the unemployment subsidy, fewer goods and services are made available, and prices for these goods and services tend to move upward.<sup>4</sup>

While it's difficult to get a tight handle on the exact size of the employers' subsidy (because the tax rate they pay is not readily available), the subsidy to workers has been estimated fairly closely. To make this estimate, Feldstein has used the benefit replacement ratio—the ratio of unemployment benefits to lost after-tax wages. The benefit replacement ratio is constructed from information on state unemployment compensation rules, employment histories of individuals, and individual tax rates including Social Security, adjusting for other factors.

Simply stated, Feldstein's results are that, during periods of reduced demand, the *higher* the unemployment subsidy to workers, the *higher* will be both the amount of unemployment and the hours worked per remaining employee. Feldstein estimates that, in 1971, the average benefit replacement ratio explained about half of temporary layoff unemployment. And an increase in this ratio from 40 percent to 60 percent, he figures, raised the predicted temporary layoff unemployment rate by about half a percentage point.<sup>5</sup>

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<sup>4</sup>This assumes that the money stock remains constant. Actually, of course, the money stock doesn't remain constant, so that the impact of changing output levels is harder to ascertain.

<sup>5</sup>Feldstein, "The Effect of Unemployment Finance on Temporary Layoff Unemployment."

Thus the incentives produced by policy-makers' attempts to ease the burden of unemployment actually led to more layoffs, he finds, and therefore to more unemployment, than would otherwise have occurred.

### WHAT DOES IT MEAN FOR POLICY?

Unemployment in the form of temporary layoff affects many Americans during their working years. No one can quarrel with the idea of protecting people from the potentially disastrous consequences of a sudden income loss. But recent research suggests that this protection has come at a high social cost. The present method of financing unemployment insurance, which does not fully tax firms to cover the payments made to their employees on layoff, results in making layoffs cheaper to the firm than they would otherwise be. The cheaper the layoffs, the more layoffs firms will make. The current taxation scheme does not provide the appropriate incentives for firms to be more careful with their layoff decisions.

Since ordinary income is taxed at a higher rate than unemployment benefits, people in the labor market are subsidized too much from the point of view of society as a whole. Workers are more likely to accept employment at firms with relatively volatile employment practices since they know that they will be supported by the unemployment subsidy. Thus the wage rates that would prevail in the market in the absence of such a subsidy are distorted and lead to a less efficient allocation of resources in the economy. If workers search for a new job while laid off, they'll search too long from society's point of view. Society gives up the output, for too long a period, that these unemployed workers could produce. If unemployed workers choose to take leisure while on layoff, society again forgoes output that it could otherwise consume.

Thus a restructuring of the unemployment insurance system apparently would help to reduce the national unemployment rate. If compensation benefits were taxed at the

same rate as ordinary income, for example, workers on layoff would have more of an incentive to search for new jobs. And those who would search as a matter of course probably would spend less time looking before accepting a job offer. In each case, the ranks of the unemployed would be thinned. To insure that taxation of benefits did not create a major burden for low-income earners, a tax rebate could be paid if a worker's income were to fall below some target level.

Forcing firms to bear the full cost of their layoff decisions also might yield a reduced unemployment rate. This would require elimination of ceilings and floors on the amount of taxes paid to finance unemployment benefits. Then firms experiencing a highly variable demand for their product would be less inclined to lay off workers since they would no longer receive a subsidy from firms with more stable employment practices and from the public at large. Such a policy shift, of course, could have adverse

side effects: firms might be less willing to make new hires, for example, if the cost of layoffs were increased. But these effects might be mitigated by limiting the time during which a firm was fully responsible for financing its layoffs to a certain number of months per worker—say, two or three months.

Perhaps it is best to view these results as suggesting a list of structural reforms designed to reduce unemployment among various groups. The unemployment compensation side effects are pertinent mainly to older, mature workers suffering short spells of unemployment, not to younger ones with few job skills. Wage subsidies or a reduction in the minimum wage may be the key elements in dealing with this latter group. But it is only when we undertake a whole range of reforms that we can hope to make substantial progress in permanently lowering the overall unemployment rate while still providing job-loss protection where appropriate.

## SUGGESTED READINGS

The four papers by Martin Feldstein that provide the background for this article are: "The Importance of Temporary Layoffs: An Empirical Analysis," *Brookings Papers on Economic Activity* 3 (1975); "Unemployment Compensation: Adverse Incentives and Distributional Anomalies," *National Tax Journal* 27, 2 (June 1974); "Temporary Layoffs in the Theory of Unemployment," *Journal of Political Economy* 84, 5 (October 1976); and "The Effect of Unemployment Insurance on Temporary Layoff Unemployment," *American Economic Review* 68, 5 (December 1978). For a somewhat different view which explicitly incorporates uncertainty, see Martin Neil Bailey, "On the Theory of Layoffs and Unemployment," *Econometrica* 45, 5 (July 1977).

## APPENDIX

The unemployment subsidy which has been shown to be relevant to the layoff decisions firms make can be defined algebraically.

Using Feldstein's notation, the unemployment subsidy,  $J$ , is defined as

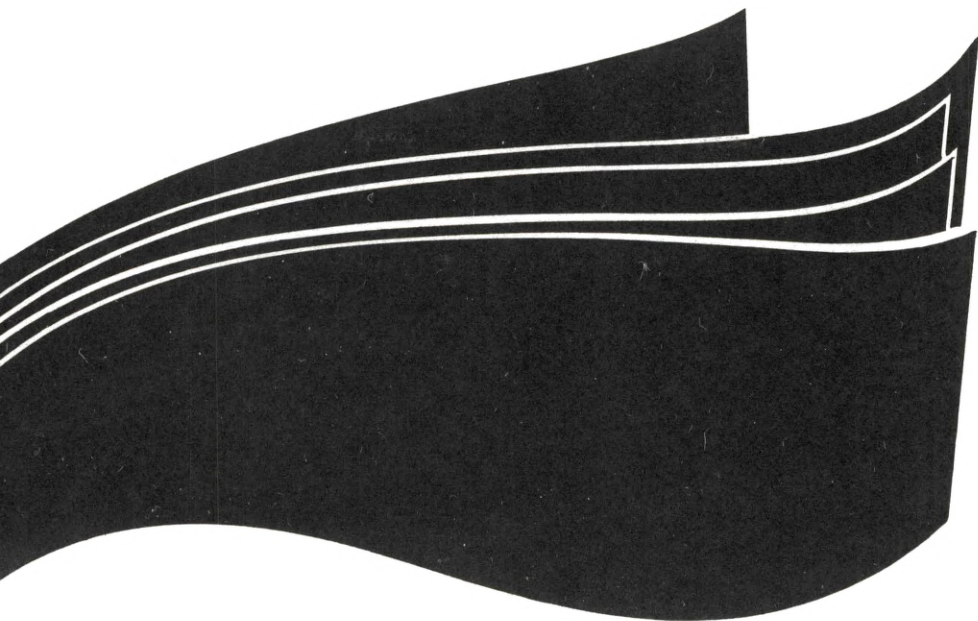
$$J = [(1 - t_b) - (1 - t_y)e]b / (1 - t_y),$$

where  $t_b$  is the tax rate on unemployment insurance benefits,  $t_y$  is the tax rate on ordinary income,  $e$  is the tax rate paid by firms to finance benefit payments, and  $b$  is the amount of benefits paid per worker on layoff. The subsidy can be eliminated ( $J$  can be set equal to 0) for any level of benefit payments. To eliminate the subsidy it is required that

$$(1 - t_b) = (1 - t_y)e.$$

The subsidy will disappear if  $t_y = t_b$  and if  $e = 1$ . That is, if ordinary income and unemployment compensation are taxed at the same rates and if firms are fully liable for payments made to their employees on layoff, then there will no longer be any subsidy to workers or firms. Feldstein shows that the higher  $J$  is, the lower employment will be during a period of reduced firm demand.

Further details are given in Feldstein, "Temporary Layoffs in the Theory of Unemployment."



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