

Some Considerations in Establishing an
Unemployment Compensation Program

by

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Introduction

Unemployment presents ongoing challenges to countries at all stages of economic development. In addition to cyclic fluctuations which continue to be commonly observed, various one-time events such as natural disasters and financial crises can occasion large, short-term increases in unemployment. As global interconnectedness increases, the cyclical risks for individual economies may become more coincident.

Unemployment compensation (UC) programs reduce the economic hardship caused by unemployment. Their cash benefits provide temporary, partial replacement of unemployment-related reductions in labor market earnings. Benefits help stabilize the income of individuals and households while also helping to stabilize aggregate demand in the macro economy.

The purpose of this paper is to examine selected issues related to the provision of UC benefits. The principal audience is the representatives of countries from the English-speaking Caribbean region. At present just one country from the region has an established UC program. Barbados instituted UC in the early 1980s and has continuously offered UC in subsequent years.

Severance pay, in contrast, is ubiquitous to the Caribbean region. If a country were to adopt UC, issues would arise in coordinating UC with severance pay. Since Mr. Carrington of Barbados is a featured speaker at this gathering, my own remarks will focus on other countries when the specifics of individual UC programs are discussed. Given the composition of countries attending this meeting, it seemed particularly relevant to emphasize the experiences of English-speaking countries and of other countries from the western hemisphere.

The paper is limited in scope and emphasizes just four topics: (1) the costs of unemployment compensation, (2) the determinants of benefit duration, (3) UC programs that have been terminated, and (4) some implementation issues. These topics are rather diverse. Thus the individual sections are more or less independent from one another with little attempt to tie them together. Conclusions are offered at the end of each section.

A note on terminology may be appropriate. Unemployment compensation (UC) programs are usefully described as being of two main types: unemployment insurance (UI) and unemployment assistance (UA). Both make payments to persons who are unemployed, meaning claimants are able to work, available for work, and (usually) actively seeking work. While each type of program varies somewhat from country to country, UI and UA have a few fundamental differences. UI programs require a period of earlier work in employment covered by the program and pay benefits to unemployed persons regardless of their individual income or the earnings of other family members. UI is received as a matter of right regardless of family income. UA programs, in contrast, require little or no past work and restrict eligibility to individuals and families whose income falls below designated thresholds. Throughout the world, most UC systems operate as UI programs or UI programs coupled with UA for persons who use up (exhaust) their right to UI benefits. UA programs are much less common, with Australia, Hong Kong, New Zealand, and Mauritius being four countries with UA. The distinction between UI and UA will not be emphasized here, and the term UC will be used in most discussions of this report. UC programs provide income support to eligible unemployed persons and their families.

The Costs of UC

The annual costs of unemployment compensation encompass cash payments to beneficiaries, “other benefits,” and the costs of program administration. In many UC programs employee contributions to public pension plans and/or health insurance programs are made by UC on behalf of recipients. These are the most common forms of “other benefits.” For present purposes, the discussion will focus just on cash benefit payments to the unemployed and will not cover “other benefits” or administrative costs.¹

In a UC program that makes weekly cash benefit payments, annual costs are 52 times the product of the average weekly benefit and the number of weekly beneficiaries.²

¹ The omission is dictated by the limited scope of this paper. Both omitted categories may be substantial relative to cash benefits. In Macedonia, for example, contributions to public pensions and to health insurance on behalf of the unemployed exceeded cash benefit by nearly 50 percent during 2000-04.

² Most UC programs pay on either a weekly or monthly basis. The text uses weekly accounting periods.

It can be shown that the payout rate for a UC program (benefits relative to covered payroll) is the product of three factors: the unemployment rate, the reciprocity rate (beneficiaries as a fraction of total unemployment),³ and the replacement rate (weekly benefits as a ratio to weekly wages). The payout rate or cost rate, in turn, determines the revenues that must be raised to finance the program.⁴ Across the full spectrum of roughly 70 countries with UC programs, cost rates for some exceed 4.0 percent while for others cost rates fall below 0.5 percent of covered wages.

To make the discussion more concrete, consider a hypothetical UC program in an economy with a 10 percent unemployment rate. Suppose the reciprocity rate is 0.50 (half receive benefits) and the replacement rate is also 0.50 (weekly benefits are half of weekly wages). In this situation, the effective payroll tax rate (taxes as a percent of total covered payroll) would have to be about 2.8 percent to generate revenues to match the implied volume of benefit payments. The 10 percent unemployment rate of this example is relevant to countries in the Caribbean area. Unemployment rate materials from the *Caribbean Development Bank Annual Review of 2003* distributed before this meeting displayed recent unemployment rates for 11 Caribbean countries. For 7 of the 11, the unemployment rate fell into the range between 7.8 percent and 13.0 percent.

All three of the factors that determine the UC benefit cost rate vary widely from one country to the next. Table 1 displays summary data that vividly illustrate this point. The table shows the mean, standard deviation, and coefficient of variation for the unemployment rate, the reciprocity rate and the replacement rate across a sample of 47 countries. The underlying data are five-year averages for 1995-99, and each country is weighted equally in the calculations since the focus is cross-country variability.

The coefficient of variation (or CV) for a variable is the ratio of its standard deviation (a measure of dispersion) to its mean or central tendency. Larger CVs show variables with wider relative variability, i e., more dispersed about their central tendency. For the three cost factors in table 1, the CV for the reciprocity rate (0.84) is clearly the

³ Throughout the paper the terms unemployment and total unemployment will refer to measures derived from labor force surveys of households.

⁴ These relationships are discussed in chapter 2 of Wayne Vroman and Vera Brusentsev, *Unemployment Compensation Throughout the World: A Comparative Analysis* (Kalamazoo: MI: W.E. Upjohn Institute, 2005). In payroll tax-financed programs, the long run ratio of benefits to payroll is closely related to the cost rate of UC benefits.

largest, while the CV for the replacement rate (0.48) is the smallest. For this group of countries (that encompass most of the world’s major countries), the UC reciprocity rate is the cost factor that displays the greatest relative variability.

Table 1. Averages and Variability of UC Cost Factors for 47 Countries, 1995-1999

	Unemployment Rate	Reciprocity Rate	Replacement Rate
Mean	9.56	0.49	0.33
Standard Deviation	6.00	0.41	0.16
Coeff. of Variation	0.63	0.84	0.48

Of the three cost factors summarized in table 1, the unemployment rate is largely beyond the control of national policymakers, particularly in the short run, as it reflects a myriad of domestic and international economic factors. However, the reciprocity rate and the replacement rate can be controlled by a country’s choices regarding its UC statutes and administrative procedures and operations. For a given unemployment rate, having a low reciprocity rate and a low replacement rate would contribute to lowering UC costs while at the same time lessening the stabilizing impact of benefits both for families with unemployment and for the overall economy. From table 1 it is clear that countries have made a wider variety of choices in determining their reciprocity rates than in determining their replacement rates.

To assess the effectiveness of UC in meeting the income support needs of the unemployed, it is crucial to know what fraction of the unemployed collect benefits. Not all who become unemployed are eligible for benefits. In most countries, benefits are not paid or are delayed and/or reduced for persons who voluntarily leave jobs and persons discharged by their employers for misconduct.⁵ Also, minimum work experience requirements are typically required. Availability for work, active work search, and non-refusal of suitable work are common requirements for continued eligibility for payments. Most typically, UC benefits are paid to experienced workers who have lost jobs through no fault of their own and are able and available for work. Benefits are also subject to

⁵ These details are highly varied across countries. Disqualifications of minimum periods are often imposed as well as so-called durational disqualifications.

maximum payment periods after which claimants are said to “exhaust” their eligibility. Renewed eligibility is achieved only after a new period of employment.

Because of disqualifications, incomplete coverage, and other factors, reciprocity rates in most UC programs (beneficiaries as fraction of unemployment) fall below 1.0. At the same time, low reciprocity rates (say below 0.20) imply few families receive income support payments and UC benefits have only a small effect in stabilizing the economy. Thus, it is important to know the number of recipients relative to total unemployment.

Charts 1 and 2 display reciprocity rates for six of the eight countries from the western hemisphere that have UC programs.⁶ The charts span the years 1980 to 2003. Of the four South American countries in chart 1, reciprocity was highest in Brazil in every year from 1988. However, the high reciprocity of the mid-1990s (generally above 30 percent) has been followed by reciprocity closer to 20 percent between 1999 and 2003.

For both Chile and Argentina, reciprocity since 1990 has been generally below 10 percent. The small increase in Chile in 2003 reflects recipients under both the old and new UC programs. This increase has continued into the first half of 2004. Note, however, that the increase of the late 1990s in Chile reflects the effects of recession on reciprocity in the old UI program. Reciprocity decreased for three of the four countries in 2003. This may be at least partly related to financing problems associated with the downturn of 2001-02 and the associated sharp increases in unemployment and UC benefit costs.

Chart 2 displays reciprocity in four large English-speaking countries. For Australia, Canada, and Britain, reciprocity was generally 80 percent or higher in the early years but then noticeable decreases occurred for all three. The decrease in Canada started around 1990 and reflects policy changes to restrict access to UC among those who quit work and increased penalty periods for disqualifications. In 2002, reciprocity was actually higher in the U.S. than Canada for the first time in more than 50 years. Britain, which pays both UI and UA benefits, restricted maximum duration in its UI program in 1996 (reducing the maximum from 12 to 6 months), and lower reciprocity seems to follow this change. Business cycle effects are most apparent for the U.S. where high reciprocity of 1980-83, 1991-92 and 2002-03 each coincide with economic recessions. Higher

⁶ Ecuador is not included in the charts as no performance data have been found. Data from Barbados are included in Mr. Carrington’s presentation.

reciency in these periods reflects increased caseloads from the regular (26-week) program as well as recipients of temporary emergency benefits.

The Australian experience deserves some additional comments since it alone among these four countries operates a purely UA-type program that conditions eligibility on income as well as other factors. Many policy initiatives have been tried to “activate” claimants but with limited success. Claimants are able to satisfy the income test in sufficient numbers to give Australia the highest reciency rate of all four since 1992.⁷ High reciency has persisted in the face of good macro performance and sharply lower unemployment, down to 6.0-7.0 percent from 10.0-11.0 percent in 1992-94.

Considering the eight countries included in charts 1 and 2, it is clear that a variety of reciency rates exist across these countries. This provides visual reinforcement regarding the high coefficient of variation for reciency rates discussed earlier and displayed in table 1.

Finally, note that range of reciency rates is considerably reduced when just the six countries from the western hemisphere in the two charts are considered. In 2003, the highest and lowest among these six were, respectively, 0.45 in Canada and 0.05 in Argentina. Including Barbados with its 2003 reciency rate of 0.23 does not alter this range. All countries in the western hemisphere with UC compensate less than half their unemployed workers.

The Determinants of Benefit Duration

Reciency rates for UC programs are strongly influenced by the average duration of benefit receipt. Average duration has many determinants, some obvious, others more subtle. Absolute constraints on average duration are imposed by the waiting period and maximum duration as defined by the UC statute. Within the western hemisphere the range of waiting periods extends from the zero- and one-week waiting periods of individual state programs in the U.S. and two weeks in Canada to a maximum of

⁷ This point is reinforced by the high reciency observed in New Zealand, which also operates an income-tested assistance system for the unemployed.

three months in Ecuador, where the long-standing UC program makes just a single lump sum payment to eligible claimants.

Having a long waiting period deters applications and reduces reciprocity since the incentive to find work is higher if benefits have not yet commenced. Since changes in waiting periods are instituted only rarely, however, there is little evidence on the effects of differing waiting periods across UI programs of the western hemisphere. Another feature affecting benefit duration is the possibility of compensating the waiting week retroactively if duration in benefit status extends beyond a specified threshold. This feature is present in a few U.S. states, including Missouri, Tennessee, and Texas.

Longer maximum potential durations have obvious effects on average benefit durations. Many countries make this maximum longer for older, more experienced workers. In addition to annual maxima there also can be multiyear maxima. This feature has been present in Finland, Greece, Norway, and Taiwan. The purpose is to limit repeat use by recording previous usage and reducing potential duration for new usage.

For more than four decades the UI system in the United States has linked maximum potential duration to the business cycle through a combination of automatic extensions triggered by high claims activity (the Federal-State Extended Benefits or EB program) and discretionary federal emergency programs (most recently the Temporary Extended Unemployment Compensation program of 2002-03). In practice, almost all the added reciprocity from these programs since the early 1980s has been provided by the federal emergency programs.

Active administration of claims also affects average benefit duration. Practices in the U.S. states vary regarding their reliance on both eligibility reviews and follow-up with claimants identified as likely exhaustees through “profiling.” Eligibility reviews are periodic meetings where claimants are required to appear at local offices at a scheduled time to meet with claims administrators and provide evidence of job search activity and describe other reemployment activities. Under profiling, claimants are assigned a profiling score at the time of the initial payment, and those with high scores (indicating a high likelihood of long duration and/or benefit exhaustion) are required to participate in activities intended to reduce duration. Eligibility reviews and profiling have been shown

in the U.S. to reduce duration through sanctioning of some claimants who do not adhere to eligibility rules and faster reemployment due to enhanced services.

Average duration is influenced both by statutes and methods of UC program administration. For countries considering adopting UC, restrictive statutes may be specified initially as a way to help ensure that costs are not unexpectedly high.

Unsuccessful Attempts to Establish UC

During the 60 years since World War II the number of countries with functioning UC programs has more than tripled, growing from about 20 to about 70 in 2005. The largest number of adoptions occurred in the period between 1989 and 1992 when more than 25 new UC programs were established, mainly in Eastern Europe and in the successor states of the former Soviet Union. As noted, there are currently eight programs in the western hemisphere, including Barbados in the Caribbean region.

Since the early 1990s, there have been six adoptions of UC: Algeria, Mongolia, Korea, Taiwan, Turkey, and, most recently, Thailand. Active consideration of UC is presently underway in Vietnam and Sri Lanka.

While the number of countries with UC programs has increased substantially during the past 60 years, there are also examples of unsuccessful experiences in establishing and maintaining programs. These can be grouped into three situations: program terminations, failure to implement authorizing legislation, and gradual withering of program scope.

Ghana and Kazakhstan both terminated their UC programs. Ghana established UC in 1973 but discontinued it in 1989. At least three factors that inhibited the successful establishment of UC can be cited. (1) Ghana has not supported periodic measurement of employment and unemployment using a labor force survey of households. There have been only four censuses since independence: in 1960, 1970, 1984, and 2000. Thus, nationally representative measurement of unemployment occurs only occasionally. (2) While there are employment offices, their scale of operations is modest compared to the total labor market. During 1994 and 1995 job seekers registered at employment offices averaged about 37,000 compared to a total labor force in 2000 of 9.0 million and

unemployment of 1.0 million. In other words, registered job seekers make up less than 5 percent of total unemployment. (3) Since independence, wage and salary employment has constituted a small and declining share of total employment: 19 percent in 1960 but only 15 percent in 2000. Because measuring the employment and unemployment status of the self-employed and of family workers is much more difficult than for wage and salary workers, this may have been the most important factor inhibiting the successful establishment of UC in Ghana. No UC performance data appear in their census publications to indicate the program's scale while it was functioning.

Kazakhstan established a UC program in 1991 but discontinued it in 1996. Two inhibiting factors identified previously in Ghana are also present in Kazakhstan. No periodic labor force survey was established. Some one-time surveys were mounted in the early 1990s (with results available when I worked there in 1996), but these have not become routine periodic events. Employment offices exist, a carryover from the Soviet era, but they did not sustain an important ongoing presence after independence because the labor market deteriorated sharply and listings of vacancies (previously required of all state enterprises) plummeted. A third inhibiting factor was a weak system of UC program financing, a problem common to many countries from the Soviet region that extended to the other Kazak social insurance programs as well.

Public pensions, health insurance, and short-term disability and maternity programs as well as UC all utilized a financing system where regional governments retained a substantial share of payroll taxes raised from local firms. Surplus regions were to submit part of revenues to the central treasury for redistribution to deficit regions. Enforcement of this regional arrangement was not successful as surplus regions did not readily share locally raised revenues. Consequently, the revenues raised in regions of high unemployment were never sufficient to adequately finance UC benefit payments even when supplemented with some monies from the central treasury. Whereas the inability to raise sufficient revenues for pensions led to an acknowledgment of pension payment arrears that were (fully or partially) honored later, local ES-UC programs in deficit regions simply did not make payments to eligible persons. The problem was most acute in regions with the highest unemployment rates.

When UC in Kazakhstan was discontinued in 1996, the client base was not substantial and the program disappeared without fanfare. In fact, the programs in both countries never served large numbers in providing placement and employment adjustment services or in providing short-term income support payments. Their initial establishment seems to have had more to do with political ideology than with a recognized need that arose from labor market conditions.

A nearby example of the failure to implement UC legislation is provided by Venezuela, which has enacted at least four different UC laws since 1940, most recently in 2001. Details of these statutes (contribution rates, the contribution base, qualifying conditions, benefit provisions) appear in various issues of *Social Security Programs Throughout the World*, most recently in the 2003 edition. Yet no performance data appear in Venezuelan yearbooks or other statistical publications because the program has never been implemented.⁸

No single explanation for this is apparent. Unemployment and employment have been measured with labor force surveys for almost 40 years. During the past five years Venezuela has held extensive discussions with the Inter-American Development Bank (IDB) on a range of potential social insurance reforms, but these have not been successfully concluded. The financing of social insurance programs has been one issue of disagreement. My understanding is that the parties do not expect this situation to change in the near future.

Several examples of UC programs with very low reciprocity rates (beneficiaries as a proportion of unemployment) also exist. In some cases, already-low reciprocity rates have actually declined further. Four countries that exemplify this situation are Egypt, Georgia, Iran, and Mauritius. For recent multiyear periods, their reciprocity rates have remained consistently below 0.05 and in most instances below 0.02. In terms of protecting the unemployed, these levels of reciprocity are close to no reciprocity.

In short, historical experiences in several countries provide examples of discontinuation of UC, failure to implement UC, and very low and very low and declining UC reciprocity rates. Factors identified as contributing to these outcomes include lack of systematic periodic measurement of unemployment, a small role of the Employment

⁸ Information gathered from conversations with staff of the Inter-American Development Bank.

Service in job matching, an employment mix with relatively few paid wage and salary workers relative to the numbers of self-employed and family workers, and defective arrangements regarding program financing.

Implementation Issues

Administration of UC may entail collection activities as well as benefits administration. In English-speaking countries UC is financed by general revenues in some countries (Australia and New Zealand) and by dedicated payroll taxes in others (Canada and the United States). Argentina, Barbados, Chile (new program), Ecuador, and Uruguay rely on payroll taxes while Chile (old program) has used general revenues and Brazil has used sales taxes. In most respects, UC revenue administration is similar to the revenue administration of other social insurance programs.

UC benefits administration has similarities to benefits administration in other short-term social insurance programs like temporary disability, sickness, and maternity programs. The client base for UC is subject to rapid turnover and several different administrative decisions are made in determining initial and continuing benefit eligibility. Program administrators must try to distinguish the unemployed from out-of-labor-force (or inactive) claimants. There are eligibility questions linked to the extent of previous work, the circumstances of the job separation, and issues of continuing eligibility after an initial benefit payment is made.

The rapid turnover of the client base (short benefit duration) and the large number of potentially disqualifying circumstances mean that UC has high administrative costs. In the U.S., administrative costs are about 10 percent of benefit payouts. This percentage, which pertains just to ongoing costs, would be higher in smaller countries where scale economies in administration would be more difficult to realize. Stated in a second way, a small country should not use the administrative cost ratio (costs as a percentage of benefit payments) from its old-age pension program as an indicator of the cost ratio for a UC program under consideration.

UC programs often utilize trust fund financing where revenues are deposited into a fund from which withdrawals are made for benefit payments. At inception, a sufficient

accumulation is needed to finance the initial months or year of benefit payments. This is frequently accomplished by having revenues collected for some period prior to the first benefit payments. Most recently, revenues were first collected in Thailand six months before benefit payments commenced in mid-2004. A second safety feature is to start the program with restrictive benefit provisions, which may be relaxed in light of actual payout experiences. Part of the issue here is the time profile of benefit payments as the program moves through the initial periods of payouts.

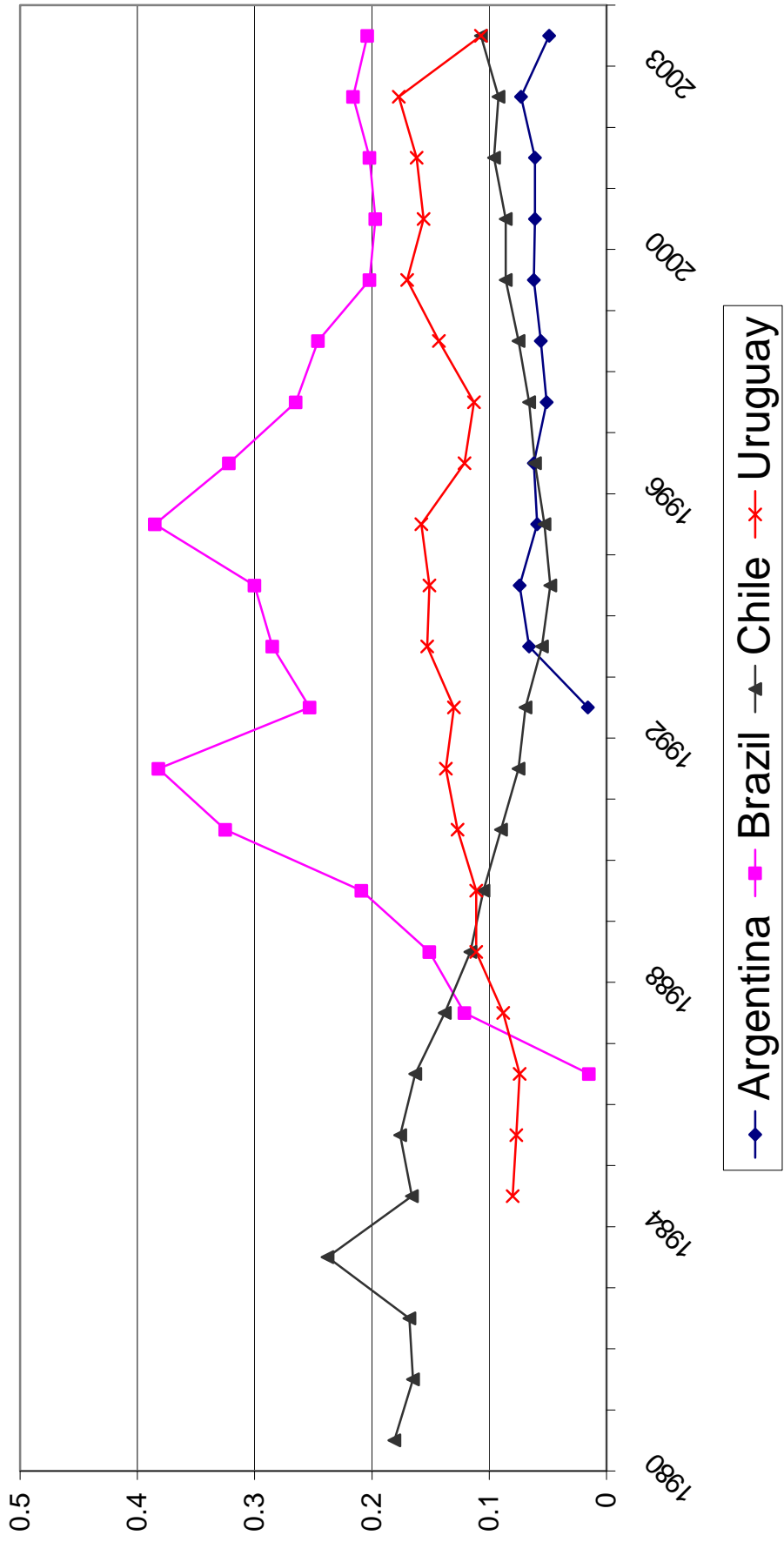
Chart 3 displays time profiles of reciprocity rates for five countries that have instituted UC programs during the past 20 years. The chart identifies the first year of benefit payments and displays reciprocity rates for the first eight years of payouts. Note that none of the transition economies are included because none had a labor force survey measure of unemployment at the onset of the transition to market economies. Because beneficiary data were available before unemployment data, the reciprocity rate was not measured from the outset of these UC programs.

The countries included in chart 3 instituted UC in less chaotic periods than the early years of transition economies. However, Argentina, Korea, and Taiwan all experienced sharp increases in unemployment two or three years after their initial years of paying UC benefits. For Taiwan it appears the multiyear constraint on compensation was operative in years five and six (2003 and 2004), causing reciprocity to decrease noticeably. The increases observed for Korea in years six, seven, and eight reflect continuing increases in coverage and eligibility among more marginal workers. Only Iran displays a pattern of small steady gains in reciprocity, but the level in year eight was only 0.05.

The patterns displayed in chart 3 do not conform to a single predominant pattern. Reciprocity does increase but the patterns are varied. Because only a small number of countries have adopted UC programs since the mid-1990s, there are only a few other candidates for examining the time path of reciprocity following implementation.

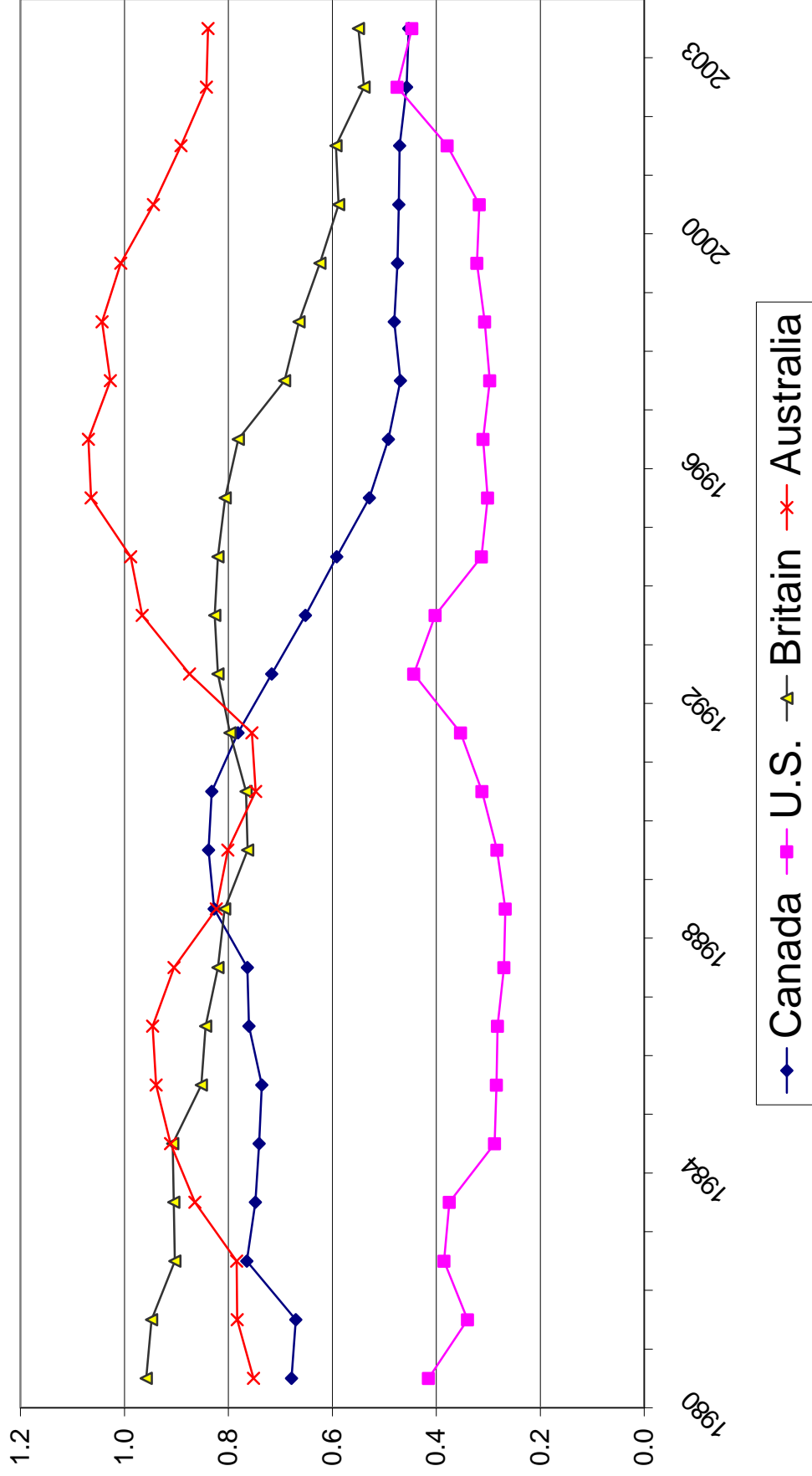
More generally, instituting a new UC program presents many challenges, and just a few have been discussed here. Turkey and Thailand, with start dates of 2002 and 2004, respectively, are the most recent of potential case studies that might provide new and useful insights into the implementation process.

Chart 1. UI Reciprocity in Four South American Countries, 1980 to 2003



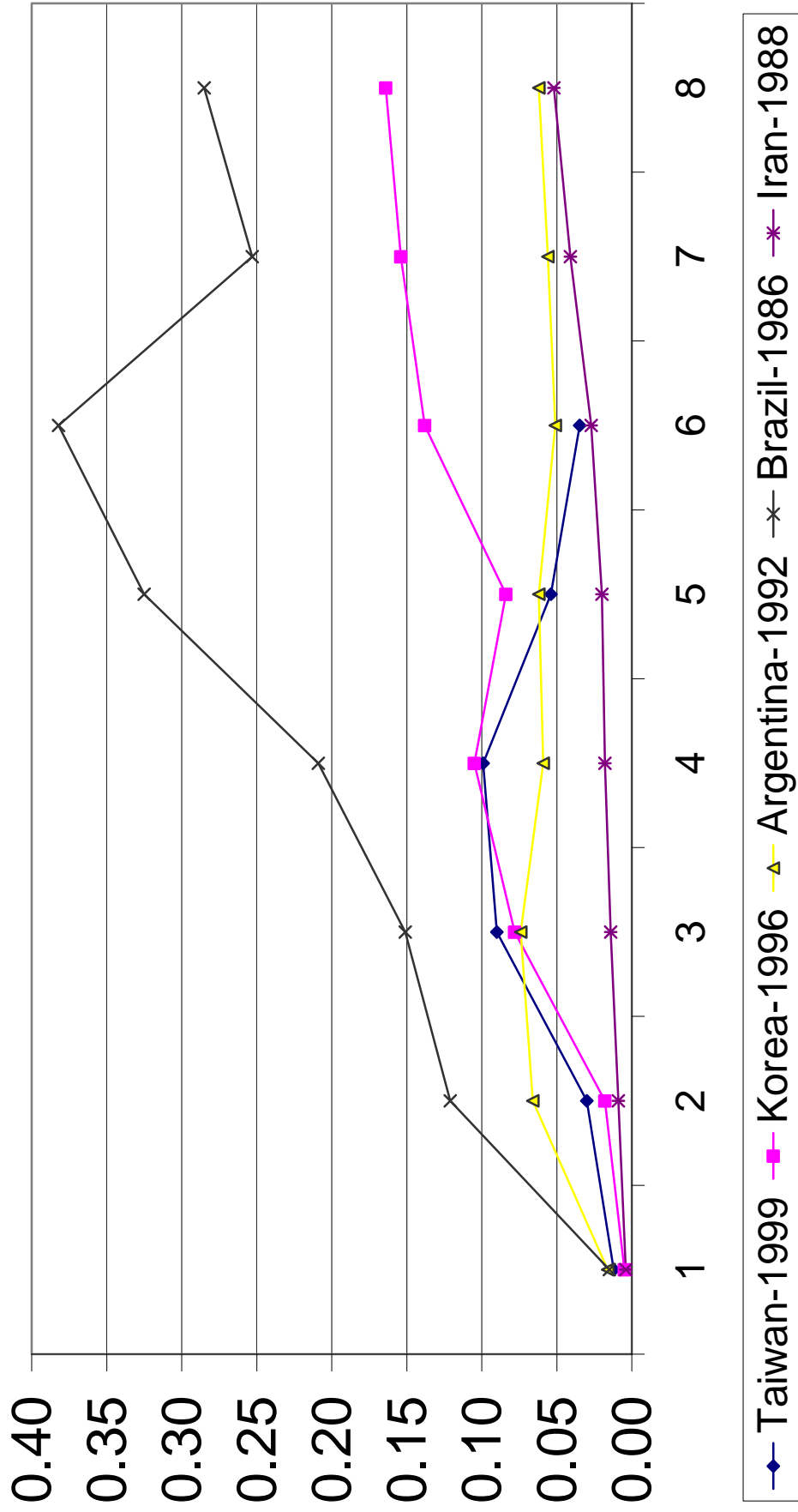
UI recipients as a proportion of labor force survey unemployment.

Chart 2. UC Recipiency in Four English Speaking Countries, 1980 to 2003



UC recipients as a proportion of labor force survey unemployment. British data include recipients of both insurance and assistance.

Chart 3. Start-up: UC Reciprocity Rate by Years of Paying Benefits



First year of paying benefits shown for each country. Lines show reciprocity rates (beneficiaries/unemployment) for the first eight years of experience.