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The effects of the unemployment insurance payroll tax on wages, employment, claims and denials

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Abstract

Following a 13-year period when all employers in Washington paid the same unemployment insurance (UI) tax rate, Washington was forced to adopt an experience-rated tax system in 1985. We use this “natural experiment” to explore both tax incidence and the effects of experience rating. We find that industry average tax rates are largely passed on to workers through lower earnings. However, our estimates imply that a firm can shift much less of the difference between its tax rate and the industry average rate. Our results also indicate that experience rating reduces turnover and UI claims, and increases claim denials. © 2000 Elsevier Science S.A. All rights reserved.

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1. Introduction

The recent experience of Washington State provides a natural setting to examine the effects of the unemployment insurance payroll tax. During the 13-year period from 1972 through 1984, all employers in Washington paid the same unemploy-

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ment insurance (UI) tax rate, but a by-product of Federal legislation then forced Washington to adopt an experience-rated system. In March of 1984, the state passed legislation that made a firm's tax rate a function of its past use of UI, resulting in a wide range of tax rates beginning in 1985. Thus, a comparison of wages, employment, claims and denials before and after the change has the potential to provide good evidence both on tax incidence and on the effects of experience rating.

More generally, this "natural experiment" provides evidence on several broader economic issues. First, many programs and employer mandates besides UI impose payroll taxes or tax-like costs on firms. The effects of these taxes or costs on wages and employment are central to the calculation of efficiency and equity consequences of policies.¹ Second, many such situations involve taxes or costs that vary across firms within the same labor market, as do UI taxes. The implications of a tax vary greatly depending on whether the tax is uniform across all firms in a market or differs within markets.² Differences in taxes across firms competing in the same labor and product markets cannot be shifted to wages or prices, and thus can be expected to have substantial employment effects. Third, experience rating imposes costs on firms that use layoffs to adjust their employment level. Thus, the evidence in this paper also has implications for the study of labor demand with adjustment costs.³

The effects of UI taxes are also an important policy issue in their own right. For several reasons, UI taxes are a potential candidate for reform. For example, with an extremely low tax base, the tax is very regressive. Also, the tax leads to substantial interfirm and interindustry subsidies.⁴ Perhaps most importantly, the imperfections in current experience rating systems may lead to more layoffs and higher unemployment than would occur under more complete experience rating. In fact, several authors attribute a substantial share of temporary layoff unemployment to incomplete experience rating.⁵ Similarly, experience rating provides an incentive for firms to be involved in the administration of benefit claims. While information on this effect of experience rating is scant, it is often argued that experience rating makes employers more likely to examine whether UI claims are justified.⁶ Finally, it is important to realize that the issues of incidence and layoff

¹For example, see Gruber and Krueger (1991); Hamermesh (1993); Aaron and Bosworth (1994).

²See Anderson and Meyer (1997).

³See Nickell (1986) and Hamermesh (1993) for surveys, and Anderson (1993) for a study of the role of UI.

⁴See Becker (1972); Munts and Asher (1981), and for recent evidence Anderson and Meyer (1993).

⁵By incomplete experience rating we mean that employers are not charged the full UI costs of a layoff. See Saffer (1982), Topel (1983, 1986), Card and Levine (1994), and Anderson and Meyer (1994).

⁶See Becker (1972, 1981), Advisory Council on Unemployment Compensation (1995), and Ashenfelter and Levine (1996), for example. Below, we briefly discuss whether employer involvement is beneficial.

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