The case for wage insurance

Summary:

- Wage insurance protects workers against the fundamental risk of earnings loss following an involuntary displacement and reemployment process.
- It was initially motivated by the need to compensate workers in trade related activities for the job and skill losses associated with free trade and globalization.
- More recently, it has been advocated as a way of providing workers with a general protection from the far-reaching disruptions associated with a changing economy.
- Wage insurance suffers from the typical problems associated with any insurance scheme, but there are several good reasons why it makes a great deal of sense.

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Wage insurance is not a new idea. It has been around at least since the 1980s, when it was presented as an effective way of addressing earnings losses faced by many workers who got displaced from their jobs in a time of growing globalization and trade liberalization. But for years its discussion was rather focused on particular situations, mostly related to the consequences of free trade, and there were very few cases of actual implementation. More recently, wage insurance has made it into the mainstream debate on how to protect workers from earnings and job losses resulting from the far-reaching disruptions associated with a dynamic and ever-changing economy. In his final State of the Union address, in January 2016, former President Obama proposed a national-level wage insurance program for the US, which would cover the entire middle-income labor force. Since then, the discussion on wage insurance has gained a new surge and several researchers and policymakers have been advocating for its implementation. In this article, I give a brief overview of this discussion, presenting the main arguments in favor and against wage insurance and some challenges related to its implementation.

What is wage insurance and how has it evolved?

Wage insurance provides a wage-supplement to workers who are forced to leave their job and move to a job with a lower pay, partially compensating these workers for their earnings loss. It is a way of protecting workers against the fundamental risk of income loss following a displacement, alleviating to a certain extent the ills of a sudden and involuntary income drop. In practice, it amounts to paying workers a portion of the difference between the wage they were earning in their previous job and the (lower) wage they face in their new job.

In its early stages, wage insurance was mostly targeted at workers losing their jobs due to the competition from foreign actors, the so-called "trade-related job loss". In their 2001 article "A prescription to relieve worker anxiety", Lori G. Kletzer (Dean and Professor of Economics at Colby College) and Robert E. Litan (Senior fellow at the Council on Foreign Relations) advocated its use in the United States as a way of decreasing worker's anxiety towards the negotiation of free trade agreements and this way minimize barriers to foreign trade and investment. In economies with great openness to trade, as well as a flexible labor market, workers are likely to be routinely displaced, which may hinder the public acceptance of free trade agreements. Wage insurance, by minimizing the earnings risk associated with job displacement, can reassure workers and make them more prone to accept measures towards trade liberalization.

The idea was embraced one year later by the George W. Bush administration through the establishment of a small wage supplement program, the Alternative Trade Adjustment Assistance (ATAA) program. The program was restricted to workers eligible for the Trade Adjustment Assistance (TAA) program, age 50 or older, who could prove they had lost their job due to international trade. In practice, the program was paying wage supplements to fewer than 6,800 workers by 2007 (the number of employed people over 55 years old in 2007 in the US was 25,722,000). But it was one of the first attempts to implement wage insurance in the US and set the seed to the broader discussion that followed.

Indeed, in his 2004 book "The new financial order: risk in the 21st century", Robert J. Shiller (Sterling Professor of Economics at Yale), proposed an extended form of wage insurance, which he named 'livelihood insurance", aimed at covering long-term economic risks to individuals' paychecks for every major career and job category. This proposal recognized that in a fast moving and increasing technological economy, economic change and skill deprecation can arise from several sources and in several sectors, well beyond the narrow category of directly trade related activities.

More recently, the 2007-2008 crisis has refueled the discussion on wage insurance and raised awareness to the need of protecting workers who find themselves losing their jobs in the midst of a generalized economic recession and only face two options, staying unemployed or taking a new job at a lower pay. Both options imply a reduction in their earnings, and while the consequences of unemployment may be attenuated to a certain extent by unemployment insurance, no mechanism is yet in place to deal with the second type of income loss. In his final State of the Union address, in January 2016, former President Obama proposed a national-level wage insurance program for the US, suggesting that all "middle-class" jobs should be covered.

Why is it a good idea?

Job loss can be very costly, including for many experience workers. It entails an immediate loss of income during the unemployment phase, which may last for months or even years, until a new job is found. This loss is currently mitigated in many countries by the benefits provided by unemployment insurance schemes. There is however another, often more serious and persistent, cost that is currently not covered by any support scheme in a majority of countries: the potential loss of income associated with taking a new job at a lower pay than the previous one. Indeed, finding new employment at a level of pay similar to the previous job's pay is often difficult. Employees lose seniority and firm-specific skills and they may not have a high enough level of formal education or on-the-job training to be able to navigate smoothly from one skill-set to another, at least not without incurring in significant costs. This forces them to re-enter the labor market as a low(er) skilled worker and consequently accept a lower pay. According to an article in The Economist, from 2011 to 2013, 4.3 million workers in the US were displaced from jobs they had held for at least three years, three fifths found a job by January 2014 and of those over 20% lost more than a fifth of their income. Unemployment insurance makes up for lost income during unemployment but not for reduced income after reemployment. This income reduction can be long-term, even permanent, prolonging the worker's struggle with a severe income shock for a period well beyond the unemployment phase and determining a loss of skills, seniority and motivation.

The desire to protect workers from these potentially big, persistent and unexpected losses alone would justify taking wage insurance into serious consideration. But there are many other valid reasons why it may be a good idea.

1. Firstly, **it speeds up the reemployment process** by providing incentives to the unemployed to accept new jobs more quickly and on a broader scope. By triggering payments only when people find a new job or are being trained for one, wage insurance discourages workers from long stretches of joblessness: every month they are out of work is a month they miss out on both wages and wage insurance. Furthermore, by decreasing the length of the unemployment spell, wage insurance also allows for a reduction in the cost of unemployment insurance and other social-welfare programs.
2. Secondly, **it decreases workers' anxiety about economic change** from whatever source, by protecting them against future losses in earnings in case they have to accept a lower-paying job in order to get reemployed. It works as a type of risk management, reducing wage risk, which in turn encourages people to take promising but risky employment opportunities, helping to spur innovation and entrepreneurial activity.

3. Thirdly, **it acts as an automatic stabilizer in crisis times**, kicking in when the economy is weakest. Following a recession, we often observe job growth with very little wage growth, with laid-off workers having an especially difficult time to find new employment paying a similar amount to what they were earning before. This contributes to stagnant middle-class incomes and a slower economic recovery. By giving a push to these workers earnings, wage-insurance also gives a push to the overall economy.
4. Fourthly, **it promotes retraining for new careers** in the wake of an industry shift as it gives a buffer during the period when the training is taking place until workers are able to acquire the full set of skills that allows them to go back to their previous skill and earnings level. This encourages workers to learn new skills in industries that are behaving strongly and hiring. Furthermore, it may give incentives to companies to provide on-the-job training as they know workers will be more easily drawn to accept a job providing it, even if it implies a wage-reduction, than to enroll in a training program while remaining unemployed, with uncertain reemployment prospects.
5. Fifthly, **it helps to reduce income inequality**, as it is mostly focused on workers with low to medium earnings, decreasing the income gap between these workers and high wage workers. This is relevant not only on equity grounds but also on efficiency grounds as high levels of inequality have been shown to be associated with lower levels of economic growth and weaker resilience to crises periods (there is by now a large and growing literature on the negative relationship between aggregate demand and inequality).
6. Lastly, **it has the potential to be supported by several sides of the political spectrum**. To left-wing parties, the program is particularly appealing by providing a protection for middle-class workers, strengthening the existing safety-net, and contributing to a decrease in inequality. To right-wing parties, the program is attractive by proving the right incentives to go back to work quickly, and by promoting risk-taking and entrepreneurial activity.

For all these reasons, wage insurance is incredibly relevant in today's economy.

What are its limitations?

Like any policy, wage insurance is not a panacea and it is important to be aware of its potential problems and limitations. Similar to other types of insurance, it introduces the possibility of moral hazard[1]. Knowing that an eventual wage loss in the case of reemployment will be (at least partially) covered by insurance, insured workers may have an incentive to take a lower-paying, and perhaps less demanding, job than the one they lost. This problem is minimized by the limited duration nature of the program, which implies that taking a lower paid job will not be beneficial for the worker in the medium to long term. There is also the possibility of moral hazard on the firm side. Knowing that workers will be willing to accept jobs at lower wages, firms may increase the proportion of low paid jobs they offer and adopt a riskier behavior, which may lead to a higher level of dismissals. To prevent this type of behavior, the government may for example implement restrictions to firing or promote collective bargaining institutions, like unions. Furthermore, it may design surveillance mechanisms to assess the adequacy of proposed wages to the required skills and tasks, refusing to give the subsidy to workers accepting jobs in companies that are evaluated as proposing artificially low wages. An additional mechanism working against this type of behavior is the minimum wage, as it prevents companies from proposing extremely low wages. This however will only affect very low wage workers, leaving out those with a relatively higher pay.

Another potential problem associated with wage insurance, also typical of most insurance schemes, is adverse selection[2]. If provided privately, with voluntary enrollment, workers with particularly insecure jobs and therefore with a higher risk of job loss will be the ones eager to sign up for the insurance, while those with a lower risk will be less interested. This will raise the cost of providing it and discourage low-risk workers (who do not want to pay a high premium since the probability of actually needing the insurance is low) to enroll, compromising the existence of the market. A careful design and pricing of the program is of crucial importance. If provided by the government, in a

[1]In economics, moral hazard denotes the type of behavior that occurs when a person has a more careless behavior, taking higher risks, because another person or entity bears the cost of those risks. In the case of insurance, the insured person will rely on the fact that the cost is beared by the insurance company, generating more of the undesirable insured event.

[2]In economics, adverse selection denotes a situation where market participation is affected by asymmetric information between the two sides of the market. In the case of insurance, insurers will often not be able to fully evaluate the risk of a person demanding insurance (known by the person herself), and the market will suffer from an overrepresentation of people bearing high risk.

universal and compulsory way, this problem can be avoided since everybody is by definition covered and therefore the market is composed by both high and low risk people, which allows for a flat, lower, insurance premium.

Finally, it should be noted that the program would not provide much help to workers with very low wage jobs or who are erratically employed, since it would probably only be available for people with some level of seniority. For these workers other mechanisms would still be needed to help them deal with earnings losses due to displacement and put a foot on the ladder towards income gains.

What are its main implementation issues?

Although the concept of wage insurance is relatively simple, its implementation raises several issues and implies choices that are often not straightforward. Regarding its eligibility conditions and generosity, for example, there are important trade-offs that need to be taken into account. The ATAA program is restricted to workers who lost their job to foreign workers, are over the age 50 and obtain a new full-time job paying $50,000 a year or less within 26 weeks of becoming unemployed. It covers up to half the difference between the worker's old and new wages with a maximum subsidy of $10,000 per year, and can last up to two years from the date of initial unemployment. This is admittedly of very limited reach. In his State of the Union address, former President Obama proposed a significant expansion: while maintaining the $50,000 income threshold, he would drop the age requirement as well as the link to job loss because of foreign competition, covering workers who lost their job for any reason. This reflects the fact that most working people in the US are under 50 and most job loss cannot be clearly attributed to replacement by foreign workers. Indeed, many jobs are being made obsolete due to technological advancement and factors like recessions and shifts in demand for products and services also eliminate many jobs. Robert E. Litan suggests that it should be expanded even more "If it were up to me, I'd be more generous than the Obama proposal, covering workers making up to $100,000 on their previous jobs, perhaps even if they held those jobs for less than three years. I would also be more comfortable if the annual payments were more generous, tying them to inflation or raising the maximum annual payment to $15,000 or $20,000". The choice of the exact design and scope of wage insurance is a delicate one, requiring a wellthought balance between: the generosity of the program, ensuring that a large portion of the workers in distress is indeed covered; and the provision of good incentives for workers to take a job quickly and not incur in risky behavior leading to repeated job loss in order to qualify several times for the program.

Another critical issue is the choice between public and private provision. As discussed in the previous section, the government may have an important role in the provision of wage insurance, as it is able to bypass some of the typical problems associated with the provision of insurance, in particular adverse selection. Notwithstanding, it would be reasonable to consider a system composed by both a public and a private provision, where the government would provide a minimum coverage for all workers and workers could then individually buy additional insurance from private insurance companies, to complement the percentage of earnings loss covered by the state. It would work as any other type of insurance, covering the risk of job market problems, and could be based on objective market wide factors for a person's occupation, reducing the possibility that the insurance might encourage people to take less demanding jobs. Firms could also include this type of insurance as a part of their benefits packages, similarly to health or disability insurance which are already offered by many companies. For example, a part of the worker's wage could be invested in a fund (without any or very little risk), which could be transferable between firms and activated by the new employer at the worker's request.

Finally, it should be mentioned that even if public provision of wage insurance is likely to be a good idea on many grounds, its costs and financing strategy still need to be carefully analyzed. It may for example be funded by a payroll tax on employers and/or employees, in which case it corresponds to a contributory insurance scheme, or by general revenues from direct or indirect taxes, in which case it works like a non-contributory social transfer. But taxes always introduce distortions in the well-functioning of markets, which need to be carefully assessed against the redistributive and efficiency benefits of the insurance provision.

Conclusion

Wage insurance is not a new idea but only recently has it began to enter the mainstream discussion on how to protect workers from the earnings risk they are increasingly facing, in a world where job and wage security are less and less of a reality. There are several reasons why it seems to be a good idea, based on both equity and efficiency reasons. So far it has only been implemented on a small scale and with very particular conditions. It is not yet possible to do a serious and complete evaluation of the impacts it would have if implemented on a bigger scale. But it is certainly worth to invest in the discussion and analysis of this policy, which is without a doubt incredibly relevant in today's economy.

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