THE UNEMPLOYMENT INSURANCE TAXABLE WAGE BASE MYSTERY

Donald O. Parsons
George Washington University* and IZA Bonn

*Economics Department/GWU
2115 G Street NW, Monroe Hall 368
Washington, DC 20052
email: dopars@gwu.edu

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The luxury of a sabbatical year at GW is gratefully acknowledged. The paper is dedicated to George J. Stigler, teacher and inspiration, whose acerbic wit delighted and entertained even as it intimidated. How else might one explain studying both industrial organization and the history of economic thought under him only to emerge a labor economist?
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ABSTRACT

Unemployment insurance experts lament the low Federal taxable wage base (TWB), last increased to $7000 per worker in 1982. The Federal TWB sets only a system minimum and by 2014 all but two states had TWBs that exceeded the minimum, opening up state TWB choice for study. States do align TWB with state payroll earnings. Indeed TWB/WAGE ratios within states have been remarkably stable for decades, though the ratio varies dramatically across states. Critics seem especially concerned about the tax regressivity of low TWBs, but the hypothesis that more progressive states choose less regressive (higher) TWBs is flatly rejected by the data. Earlier UI analysts focused on employer equity, and the resistance of low cost, high-wage (stable) employers to subsidizing high cost, low-wage (unstable) employers. These analysts provided convincing evidence that (i) employers believed this to be the key issue, and (ii) the TWB did redistribute the insurance premium burden in the hypothesized direction. Across states—wage levels constant—economies characterized by large (stable) firms and greater income inequality are associated with lower TWBs. Apparently critics were right to imagine a link between wages and the TWB, but ignored the fact that this matching could be done better across location.

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The determination of the tax base is the most difficult and least satisfactory task in the financing of unemployment insurance.
Joseph Becker (1981, p.112)

I. Introduction

For decades, UI experts have expressed frustration with the stubbornly low Federal taxable wage base (TWB), the (minimum) upper-bound on worker earnings subject to the UI payroll tax that states can impose, Haber and Murray (1966, p.378), Topel (1990, p.132), Levine (1997, p.352), Vroman (2011), and Vroman and Woodbury (2014, p.261), among others.¹ This was last increased in 1982, to $7000 per year.² The forces that determine the TWB are not well established, but a wage base independent of wage levels would seem an unlikely design feature. The Federal TWB is however a system minimum, and by 2014 all but two states, Arizona and California, imposed a TWB above the Federal minimum, Figure 1A. (Figure 1B provides the corresponding distribution of tax rates (TAX/TWB) across states). The TWB exceeded $35,000 in Alaska, Idaho, and Oregon and $40,000 in Washington and Hawaii. The wide variation in TWB across states permits us to explore its political economy and perhaps uncover the reason for the low Federal TWB.

UI contributions (taxes) per employee vary substantially across states, from a little over $100 in Nebraska, Tennessee, and Louisiana to more than $900 per worker in Alaska, Oregon, and New Jersey in 2014. These payments translate directly into benefit payouts. In the U.S. system, states operate independent systems, and contributions (taxes) collected from a state’s employers are expected to cover the aggregate benefits distributed to the same state’s unemployed workers, at least over time.

¹ Vroman (2011) is careful to point out that the desirable system-wide TWB increase could be implemented by the states as well as a Federal minimum, but argues that the latter would be more convenient.
² A notable exception is Becker (1981). See Section VIII.
Employers have an obvious interest in the size of these tax payments.³ Less obvious is employer interest in the multiplicative components that generate the tax per worker (TAX), namely the taxable wage base (TWB) and the tax rate (TAX/TWB):

\[ TAX = TWB \times \left( \frac{TAX}{TWB} \right) \]

Across states, a graph of the two factors is not a simple inverse function only because of the large differences in total contributions per worker (TAX) and temporary mismatches of outflows and inflows, Figure 2. What does it matter if the first term is smaller and the second larger?

<char>figure 2</char>

Despite much agreement that the Federal TWB is too low, the underlying logic of state choices of the taxable wage base (TWB) and the tax rate (TAX/TWB) is not well understood. At the system level for example, the benefit replacement rate has been quite stable over the first 50 years of the system despite the limited adjustment in the tax base, Levine (1997). Critics of the low Federal TWB offer a variety of arguments in support of raising the Federal minimum TWB, often a tax incidence argument. Treating the UI “contribution” per worker as an individual tax, a payroll (flat) tax with an upper bound on the tax base is regressive—and raising the upper bound makes it less so. Whether this is an important factor in TWB setting is an empirical question.

Earlier scholars focused on UI as social insurance and considered taxes net of expected benefits (fair insurance premiums), imposed on the employer—which employers should be subsidized, which should subsidize others? In this framework, often the observed TWB reflects a political equilibrium between high cost, high turnover (low wage) employers seeking cost relief and low cost, low turnover (high wage) employers disinclined to fund that relief. In this argument, raising the TWB makes the system increasingly unfair to stable employers.

³ For reviews of UI financing, see Becker (1981), Topel (1990), and Vroman and Woodbury (2014).
In the next section the somewhat unusual structure of the U.S. Federal/State UI system is briefly summarized. The Federal Government, the States, employers, and workers all make decisions that affect system performance and costs. Recent theories of TWB setting are then considered (Section III), including the common argument that low TWBs are unacceptably regressive. Section IV turns to the data and first considers the dynamics of TWB, exploring the impact of the often large cost shocks of the Great Recession on state TWBs. Only the largest cost shocks induced substantial adjustments in TWB. The persistent differences in the level of TWBs across states are then examined in Section V. Consistent with expert intuition, TWB is systematically increasing in the State’s average wage--state TWB/WAGE ratios are remarkably stable across the decades, though differences across states are dramatic. The individual worker (tax-equity) hypothesis that more progressive states would adopt higher TWBs is then tested and rejected.

An alternative hypothesis, labeled here the employer (insurance-equity) argument, is introduced in Section VI. This argument frames TWB choice as an extension of experience rating, with the primary conflict arising between high turnover (low wage) employers and low turnover (high wage) employers. The employer-equity hypothesis is formally modeled, and evidence in support of the hypothesis presented. Policy conclusions for the ideal Federal TWB are then drawn in Section VII. Evidence from Anderson and Meyer (2006) reveals that the current state TWB structure is approximately insurance neutral across wages and that a large increase in the Federal TWB would sharply shift net insurance payouts toward low wage (less stable) workers, making the UI system a very poor investment for stable employers. Apparently critics were right to propose a link between payroll wages and the TWB, but ignored the fact that this matching could be done better across location. Section VIII briefly concludes.

II. Key Features of the U.S. UI System

The U.S. unemployment insurance system can best be viewed as a set of state systems loosely guided by Federal legislation. The core inducement for states to set up UI programs in the Social Security Act of 1935 was a Federal tax on employer payrolls, most of
which would be returned to the individual states to fund a Federally approved unemployment insurance program. The odd tax structure arose from a concern that, though the Federal government’s constitutional right to tax was well established, its right to demand that a state offer a social program was not.4

The original Social Security Act of 1935 directed that the UI payroll tax in a acceptable state plan applied to all earnings, though that changed quickly (1939) with the Federal government requiring that states impose a TWB of at least $3000 (at the time the maximum taxable wage under the Social Security retirement system). The current payroll tax is 6.0% on a TWB of $7000, of which the Federal government “returns” 5.4 percent to the individual states if the state has in place an approved UI program.5 The residual 0.6 percent is used to finance state administrative costs and the Federal share of extended benefits.6

The U.S. UI system is at its core an employer-based system. Program designers were concerned that the program might subsidize unstable jobs at the expense of stable ones, with predictable and unappealing consequences, and experience rating became a hallmark of the new program. With experience rating, a firm’s tax rate varies directly with the balance between the benefits distributed to the firm’s employees and the firm’s own contributions (payroll taxes).

“Perfect” experience rating would imply that all benefits paid to a firm’s workers would be pre-paid or repaid by the firm, essentially a pure (employer) savings account system, with borrowing rights if asset levels in the system fall below zero. If interest charges on assets or debts in the system are at market rates, this arrangement could be considered equivalent to market transactions, except of course for the essentially compulsory aspect of the system as a whole. If perfect, experience rating would eliminate all redistribution across employers.

4 For discussions of the early history of the UI program, see Douglas (1936) and Baicker, Goldin, and Katz (1997).
5 And is not in arrears in the repayment of loans from the Federal government, in which case a credit reduction applies.
6 The Federal portion of the tax, designed to cover administration and later its share of extended benefits, will be ignored here. See Parsons (2000) for a discussion of administrative cost allocations to the states.
Each firm would be assigned its own tax and the division of the total tax bill into its components, TWB or TAX/TWB, would be irrelevant.

Perfect experience rating is not feasible and perhaps not even desirable. Bankruptcy in a balanced budget system requires that surviving employers pay contributions in excess of their own employees’ benefit draws. Other non-insurance expenditures, including family benefits, may be “socialized” and not charged to the individual firm.\(^7\) The DOL ETA measure of total benefits charged to employers, the experience rating index (ERI), varies from two-thirds in Maryland and Nebraska to 90 percent in Missouri in 2014, DOL (2015).

States also impose minimum and maximum tax rates, which serve to limit experience rating. Were benefit demands random across time, this would in fact offer employers some insurance against a bad year. Alas that is not the case, with low-skilled, highly seasonal firms regularly benefiting from the upper bound of the tax rate at the expense of high-skilled, stable firms at the lower bound. In a detailed study, Anderson and Meyer (1993) reported that the UI system systematically redistributes resources (i) from stable industries (the white collar and service sector) to less stable ones (construction, manufacturing, agriculture and mining) and (ii) from some firms within industries to others, over long time intervals as well as short.\(^8\)

Debate over the appropriate TWB (or its total absence) immediately followed passage of the act. In a contemporary account of the passage of the Social Security Act of 1935, Paul Douglas (1936, pp.258-259) proposed an individual worker equity argument for setting a taxable wage base (as Congress soon did). In particular he noted that that the fifteen states that had already approved UI systems had all imposed an upper bound on benefits (the maximum weekly benefit amount). Drawing a parallel with the SS retirement system, he argued that it seemed inappropriate to tax workers on wages that would not translate into benefits—the TWB should be that level of earnings at which taxes no longer

\(^7\) Only seven states and DC have UI systems that include family benefits, and taxing these would encourage employers to hire only workers without dependents.

\(^8\) See also Becker (1972).
translate into higher benefits. As Douglas remarked, “The limitation of benefits to $15 a
week will, however, prevent the upper-salaried group from receiving an undue amount of
protection; and indeed will result in their giving indirect aid to the lower salaried workers.”
Douglas (1936, 258-259). He proposed, “In order to avoid offending the upper-salaried
employees, it will, however, be wise if the workers are not asked to make any payments on
that portion of their wages and salaries which is above $30 a week or the approximate
amount which would be insured under a 50 per cent benefit scale.”

The link of the TWB with the social security (SS) maximum taxable income was soon
broken. The SS tax base has risen sharply with wage inflation while the UI taxable wage
base has not, though it is important to note that the two serve quite different program roles.
In the retirement program, benefits increase with the earnings taxable wage; in the UI
system, benefits increase with the worker’s full earnings (up to a separate benefit cap) and
not with the worker’s taxable wage base.

III. TWB Setting: The Recent Struggle for Explanations

The question of what drives the UI TWB, state or Federal, and what should drive that
base has been the subject of much discussion. Although simple theory suggests the TWB
does not matter if the tax rate is flexible, experts appear uniformly to believe that the Federal
TWB should increase with wage inflation. After intensive study, the 1996 report of the
Advisory Council on Unemployment Compensation proposed a series of changes to UI
regulations, including Recommendation 1996-20:

The Federal taxable wage base should be raised to $9,000...[and] should be
adjusted annually by the Employment Cost Index.

The Report offered the following argument for this recommendation:

...empirical evidence indicates that, holding all else constant, those states with higher
taxable wage bases have higher UI trust fund reserves. Thus, in order to promote
the forward funding of the UI system—a federal responsibility—one of the most
effective mechanisms is to raise the minimum taxable wage base.

The science behind this strained argument—who can seriously imagine that the most
effective way to increase reserves is to increase the Federal minimum TWB?—is a fixed
effect panel regression of reserves on a variety of UI system parameters and economic conditions, in which TWB has a significant positive effect, Grundman (1995). Reviewing Grundman’s results, one finds that imposing a disqualification for quits or breaking up unions would also “work,” Grundman (1995, Table 4, p.N19).

Other experts came to a similar policy conclusion, offering a variety of justifications. Levine (1997) predicted that the TWB restriction would induce a funding crisis in the system even as he presented a graph (Figure 8.5, p.335) that illustrates (i) a dramatic decline in the ratio of TWB to average wages between 1938 and 1997, and (ii) a steady (and in recent years increasing) benefit replacement rate, the principal measure of UI generosity.

A number of recent authors, including Topel (1990), Levine (1997), and Vroman and Woodbury (2014), focused on an unattractive feature of UI financing. Viewed in isolation, the tax system is regressive, with workers with wages below the TWB contributing a larger share of their earnings to the program than those above the TWB. This is a straightforward implication of a flat tax with an upper bound. Increasing the TWB reduces regressivity or, conversely, freezing TWB in a period of increasing wages increases regressivity. Whether this fact translates into an empirically important determinant of state TWB choices is an empirical question.

IV. The State TWB Data

If tax regressivity concerns dominate public thinking on TWBs, state TWBs should, other real factors equal (earnings levels, unemployment rates, etc.), vary directly with the state’s political climate and its political preferences, its degree of support for low wage workers (progressivity). The freeing of state TWBs from an effective minimum gives us a chance to examine the validity of that conjecture.

a. Persistence and Change: Lessons from the Great Recession

Before turning to the determinants of state TWBs and especially the link to political attitudes, we explore aspects of the dynamics of state TWB choice, specifically the state tax (base, rate) responses to the large cost shocks of the Great Recession. In particular the
Great Recession of 2007-2008 and the slow labor market recovery that followed caused UI benefit payouts and therefore tax liabilities to increase sharply in most but not all states. The percentage change in States total contributions per worker (TAX) between 2008 and 2014 varied from negative 11 percent (Tennessee) to plus 165 percent (Vermont) and a staggering 655 percent in Hawaii, which had to offset an unfortunately timed reduction in contributions just prior to the onset of the recession. The taxable wage base (TWB) however was remarkably stable between 2008 and 2014, with two prominent exceptions—Hawaii of course and also North Dakota which implemented large TWB increases. The adjustments in tax rates across states were more widespread. The responsiveness of state TWB and TAX/TWB choices to large increases in revenue needs are illustrated in Figure 3.

If one looks at the means of changes in TWB and TAX/TWB across fractional changes in total state taxes per worker between 2008 and 2014, it is clear that TWB changes only in response to especially large changes in revenue needs, Figure 3, Panel A, while TAX/TWB adjusts more or less proportionately to smaller ones, Panel B.

b. The TWB-WAGE link

Although state TWBs vary modestly in response to revenue demands in the Great Recession, that may be because this period is defined by sharply higher, but temporary unemployment rates. UI experts are uniformly supportive of a TWB that increases with payroll earnings across time (and presumably across states), and it seems that state policy makers are as well. The ratio of TWB to average payroll wages is remarkably stable over time. The scatter diagram of the ratio at the dates two decades apart, 1994 and 2014, illustrate this regularity, Figure 4. The simple correlation across states in the TWB/WAGE ratio in 1994 and 2014 is 0.91.

9 A news account of the Hawaii TWB event can be found at Wiley (2009).
Equally obvious, the (stable) TWB/WAGE ratios chosen by the states vary dramatically, from a little over 10 percent to almost 70 percent. A look at the scatters of TWB by WAGE in 1994 and 2014 illustrate this diversity (and the constancy of the relationship over time). Cross-state scatter of TWB level levels by average payroll wages in the State are presented in Figure 5, Panels A and B. Three prominent outliers—low TWB and high WAGE—are noted, NY, CT, and DC.

What might explain these large differences in State choices of TWB for a given WAGE? Before investigating various hypotheses proposed by UI experts, consider a base model with lnTAX and separately its components, lnTWB and lnTAX/TWB, as dependent variables and lnPRWAGE and lnIUR, the natural logs of average payroll wages and the insured unemployment rate as covariates. The impact of these two explanatory variables on average tax contributions per worker (TAX) is both strong and unsurprising. Because of the (long run) budget balancing requirement, the total UI charges reflect total benefits expended, and therefore presumably benefit generosity, which is strongly linked with average wages, and unemployment incidence. The regression coefficients, standard errors, and the coefficient’s significance are reported in Table 1, Column 1. The R Squared of 0.78 reveals the almost definitional importance of these two factors in total expenditures per worker, with the payroll wage elasticity being somewhat greater than one (1.3) and the insured unemployment rate modestly less than one (0.79).

More interesting is the partition of the lnTAX per worker into its (multiplicative) components, ants: lnTWB and lnTAX/TWB. These are less easily “explained”, with an R Square of 0.44 for the base and 0.31 for the rate, Columns 2 and 3 respectively. The estimates reveal that TWB is primarily driven by payroll earnings and not by the insured unemployment rate, Columns 2. The TWB-to-payroll wage elasticity is 1.6, the insured

10 Variable definitions and sources are reported in Appendix Table 1, means and standard deviations in Appendix Table 2.
unemployment elasticity only 0.15. This is consistent with the argument that the TWB reflects relatively permanent factors (wage levels) while the tax rate absorbs temporary shocks (the unemployment rate). The insured unemployment rate has a strong positive impact on UI expenditures, which must then find its way into a higher tax rate and does, Column 3. That is the case with the tax rate elasticity with respect to the insured unemployment rate of 0.64 and with respect to payroll wages of -0.32, negative but insignificant.

V. TWB Setting: The Worker (Tax Equity) Hypothesis

Expert concerns about the regressivity of the tax with a low TWB suggest a simple hypothesis that might explain state differences in TWB given these fundamentals: “progressive” states presumably prefer less regressive policies and therefore higher TWBs for a given level of payroll wages and unemployment rates. The ideal measure is difficult to define so three plausibly alternative measures are in turn added to the standard lnTWB model:

PROGRESSIVITY, an index constructed by political scientists, Devin Coughley and Christopher Warshaw (2016), designed to measure the liberalism of state policies.

DEMOCRAT, the simple average of the proportion of the two legislative houses that are democrat (DC and unicameral Nebraska are not included in these regressions) National Conference of State Legislators (2014).

UNION, the proportion of a state’s wage and salary earners who have a union affiliation. BLS (2014).

The progressivity indicator is available for the 50 states and is a positive index of the progressivity of state laws, centered on zero (mean 0.04) in 2014 with a range of -2.53 (Missouri) to +2.5 (California and New Mexico)—with a greater positive signaling more liberal. The Democrat measure is a simple average of the fraction of state legislators in each of the two houses, with DC and unicameral Nebraska not included. The average measure is 0.46, ranging from 0.133 (Wyoming) to 0.911 (Hawaii). Average state union density in 2014 was 11.4 percent of all wage and salary earners, ranging from 3.2 percent
Definitions of all variables and their means and standard deviations can be found in Appendix Tables 1 and 2.

A review of the regression results in Table 2 reveals that one cannot reject the null hypothesis of no effect of a state’s “progressive” stance on the level of TWB chosen by the state at the two-tail 0.05 percent level. The p-value of DEMOCRAT or UNION is somewhat higher than PROGRESSIVITY, but not in a substantial way. Of greater importance to the progressivity question, the coefficients in all three cases are negative, not positive as one might expect—the best estimate is that more progressive states, however measured, impose lower, not higher TWBs.

VI. TWB Setting: The Employer (Insurance) Equity Hypothesis

An attractive alternative hypothesis for the determination of TWB emerged in the earlier UI literature but apparently fell into neglect. This hypothesis focused on employers and asserts that UI is a social insurance scheme so that redistribution might better be judged by expected net taxes (taxes paid less expected benefits received), essentially the fairness of insurance premiums. This reverse progress did not go unnoticed by economists whose careers bridged this period. As one of these earlier contributors (and a co-chair of an earlier Federal UI commission), Joseph M. Becker, lamented on this topic in an earlier study.

The national commission [National Commission on Unemployment Compensation] has shed little new light on the problem of the taxable wage base. Both its final report and the study paper it commissioned are less adequate treatments of the problem than were in existence before the commission began its work. Becker (1981, p.111, footnote 2)]

The same might be said of the Advisory Council on Unemployment Compensation study of 1995-1996.

In their classic 1966 study, Haber and Murray (1966) devoted considerable attention to the UI tax base/tax rate tradeoff. They reported on what they believed to be the key public choice conflict:

Spokesmen for high-wage, stable employers have steadfastly opposed increases in the tax base, especially on a federal basis, contending that it would be more equitable to raise any additional revenue needed for unemployment benefits by increasing the tax rate on unstable employers who, they contend, are also low-wage employers. Haber and Murray (1966, p.358)
Similarly Becker (1981, p.114) noted that the American Retail Federation made the same argument as the employers made two decades earlier to Haber and Murray.

When the American Retail Federation stated its policy regarding unemployment insurance in 1980, it recognized that to some extent financial logic would have to yield to political pressures in the selection of a taxable wage base. “This is the most controversial issue among employers, as it tends to pit high-wage and steady employers [those paying high annual wages] against low-wage employers and those having large numbers of part-time or seasonal employees [those paying low annual wages.] Therefore, establishing a wage base above the minimum usually requires a compromise.

The employer-equity hypothesis then involves a political balance between low wage/high turnover employers and high wage/low turnover employers, with an increase in TWB shifting the tax burden from the former to the latter (once tax rates adjust downward to maintain a constant tax revenue).

Haber and Merrill (1966) provided evidence that the impact of a higher TWB on the distribution of the tax burden was much as the executives believed. They reported on a 1961 study undertaken by the New York State Department of Labor (on UI administrative data) that confirmed the impact of higher TWB on the distribution of taxes. New York used a reserve ratio accounting method, essentially treating each employer as a responsibility center for a stock of net contributions (cumulative taxes less benefits). The study calculated the impact on taxes and net benefits of a hypothetical change in the TWB from the prevailing $3,000 to $4,800, partitioning employers into those with positive balances (low turnover employers) and negative balances (high turnover employers). Positive balance firms, those who have paid taxes in excess of benefits accruing to their workers, would experience a tax increase of 35%, those with negative balances only 25%. In this instance, at least, the stable employers, who argued against an increase in TWB, were correct in assessing the equity effect of the increase.

Becker reported on a 1965 simulation of the impact of an increase in the TWB from $3000 to $4800 under state of Michigan rules. “The three high-wage firms contributed more than twice as much as the three low wage firms: [an additional] $584,800 as against $208,900.” (p.121).
a) A Formal Model

The Douglas argument appeals to individual worker equity while the Haber and Murray discussion refocus the discussion on employer equity. If firms are a collection of similarly skilled workers, as they are to a considerable extent, the worker/employer distinction blurs. What emerges as important in any equity discussion is differential turnover (and unemployment) rates. A formal model illustrates these equity effects in setting of the TWB.

The Model. Consider firms in a competitive labor market with wages linked to skills in the usual way. Assume each firm employs N workers and that workers are skill-homogeneous within each firm. There are firms of varying skill (wages) which are say uniformly distributed over the wage interval \((\underline{w}, \overline{w})\) with density \(\omega = \frac{1}{\overline{w} - \underline{w}}\). Administrative costs are assumed to be negligible throughout.

The UI program is assumed to have several key features. Unemployment benefits are assumed to be a fixed proportion, say \(b\), of wages up to a wage maximum of \(\overline{w}^B\), so the worker’s UI benefit if separated from firm \(i\) is \(B_i = bW_i\) if \(W_i \leq \overline{w}^B\) and \(B^{MAX} = b\overline{w}^B\) otherwise, where \(B^{MAX}\) denotes the maximum UI benefit. Benefits are funded by a payroll tax say \(t\), of wages up to a wage (and tax) maximum of \(\overline{w}^T\), so that firm \(i\)’s tax liability is \(T_i = tW_i\) if \(W_i \leq \overline{w}^T\) in period \(i\) and \(T^{MAX} = b\overline{w}^T\) otherwise. Presumably \(\underline{w} \leq \overline{w}^B, \overline{w}^T \leq \overline{w}\).

In the UI system, the total budget across all firms must balance over time; assume that to be the case in this single period model. This means that the impact of a change in TWB will have two effects: (i) those firms with skills indexed above \(\overline{w}^T\) will be made worse off because total taxes will be higher, and (ii) all firms will see an easing of the tax rate to maintain the balanced budget. Those below the initial TWB are better off, those above worse off.

Net transfers \(\tau_i\) (expected benefits less taxes paid) for the \(i^{th}\) firm (or its worker in these skill-homogeneous firms) are:

\[\tau_i = E(L_i) - T_i = \varphi_i bW_i - tW_i = (\varphi_i b - t)W_i,\]
where $E(L_i)$ is the $i$th firm’s expected (insurable) losses—expected benefit payouts. Taking benefit generosity as fixed, the balanced budget requirement on tax collections requires that the payroll tax $t^*$ be set so that transfers sum to zero:

$$\int \omega \tau_i(t^*) = 0,$$

where again $\omega$ is the wage density.

**Equal Turnover (Unemployment) across Firms.** Consider a situation in which the probability of layoff (and UI benefit receipt) is the same for workers in all firms, $\varphi_i = \varphi$ for all $i$.

At the time Douglas was writing, there was a benefit maximum but all wages were taxed: $\bar{w}^B < \bar{w}^T = \bar{w}$. The (equal) number of workers in each firm is also irrelevant to budget balancing and will for notational simplicity be suppressed. The balanced budget (in expectation) requires that expected benefits and taxes be equal. In this case expected benefits per firm are:

$$E(T) = \varphi b [\alpha^B \frac{1}{2} (w^B + \bar{w}) + (1 - \alpha^B)\bar{w}^B],$$

where $\alpha^B = \frac{\bar{w}^B - \bar{w}}{\bar{w} - \bar{w}}$ and $1 - \alpha^B = \frac{\bar{w} - \bar{w}^B}{\bar{w} - \bar{w}}$ and again $\varphi$ denotes the probability of a claim. In this special case in which all payroll earnings are taxed, average taxes ($\bar{T}$) are

$$\bar{T} = t \frac{1}{2} (\bar{w}^T + \bar{w}) = t \frac{1}{2} (\bar{w} + \bar{w}).$$

The balanced budget then requires:

$$E(B) = \bar{T}.$$
the tax rate should equal the expected benefit rate. At this point all firms are paying taxes equivalent to market insurance rates.

**Unequal Turnover (Unemployment) across Firms.** Job turnover is however strongly *decreasing* in wages.\(^{11}\) Formalizing that stylized fact:

\[ \varphi_i = f(W_i), \quad f' < 0. \]

With fixed tax and benefit rates, this implies that expected benefit payouts will increase more slowly than will taxes, and net benefit transfers will fall for workers with higher wages, ceteris paribus.

Consider a structure of TWB and maximum benefits in which \( w < \bar{w}^T < \bar{w}^B < \bar{w} \), essentially the current situation in the U.S. In this case firms are partitioned into one of three wage intervals, (1) when wages are below both caps, (2) when wages are above \( (w^T) \) TWB and below \( \bar{w}^B \), and (3) when wages are above both policy parameters (both caps are effective).

\[
\begin{align*}
R_1 & \quad \tau_i = \varphi_i bw_i - tw_i \quad \text{if } w_i \leq \bar{w}^T, \bar{w}^B \\
R_2 & \quad \tau_i = \varphi_i bw_i - t\bar{w}^T \quad \text{if } \bar{w}^T \leq w_i \leq \bar{w}^B, \\
R_3 & \quad \tau_i = \varphi_i b\bar{w}^B - t\bar{w}^T \quad \text{if } w^T \leq \bar{w}^B \leq w_i
\end{align*}
\]

Taking the benefit rate as given, the tax rate that will lead to a balanced budget \( t^* \) would be:

\[
\int_{R_1}^{R_2} \tau_i(t^*: \varphi_i, w_i) + \int_{R_2}^{R_3} \tau_i(t^*: \varphi_i, w_i) + \int_{R_3}^{R_1} \tau_i(t^*: \varphi_i, w_i) = 0
\]

The identity of losers and gainers in this institutional regime depends on the relationship between attrition rates and wages. As above, if \( w < w_i \leq \bar{w}^T = \bar{w}^B = \bar{w} \) and \( \varphi_i = \varphi \), then all workers will pay fair premiums, premiums equal to expected losses. If \( \varphi_i = f(W_i), \quad f' < 0 \), then net transfers, \( \tau_i = \varphi_i bW_i - tW_i \), may either fall or rise with the firm’s wage level.

\[
d \tau_i = [f' b + \varphi_i b - t] dW_i
\]

To illustrate, consider a specific functional form for the turnover function:

\[\text{\footnotesize \footnotesize 11 See Parsons (1972) and Pencavel (1972) for early attempts to explain the foundations of this relationship.} \]
Turnover varies inversely with payroll wage levels. The three transfer functions in this case become:

R1: \[ \tau_i = ab - tw_i \] if \( w_i \leq \bar{w}^T, \bar{w}^B \)
R2: \[ \tau_i = ab - t\bar{w}^T \] if \( \bar{w}^T \leq w_i \leq \bar{w}^B \)
R3: \[ \tau_i = a \frac{\bar{w}^B}{w_i} b - t\bar{w}^T \] if \( \bar{w}^T \leq \bar{w}^B \leq w_i \)

In this case, expected benefits are independent of wages (the probability of a claim goes down as the cost of a claim goes up). The tax contribution rises proportionately to wages, so that transfers become more negative as wages increase, ceteris paribus.

\[ d\tau_i = -tdW_i. \]

For transfers to be insurance equitable, it would be necessary for the tax rate to fall for higher wage workers:

\[ t_i = \frac{ab}{\bar{w}_i}. \]

In R1, net benefit transfers would fall with earnings, though by progressively less as wages increase. There would be no change in expected benefits (the fall in turnover rates exactly offsets the increase in benefits in this model) and an increase in taxes. In the second region, net transfers are constant; benefits are constant because turnover rates decline as benefits rise, and revenues are constant because of the TWB cap. Among the highest earning workers (R3), transfers decline once again, in this case because expected benefits are falling (benefits are now fixed and the turnover rate falls with earnings) while taxes are, as in R2, fixed by TWB.

What then is the impact of an increase in the taxable wage base (\( \bar{W}^T \)) on this system? Before imposing the balanced budget restraint, the effect of an increase in TWB would be twofold: (i) to extend the range of R1 while reducing the range of R2; and (ii) to decrease benefit transfers in R2 and R3. If the system was previously budget-balanced, then the increased net revenues would place it in surplus, and the balanced budget...
requirement would call for a reduction in the payroll tax rate t. Workers in R1 would be net beneficiaries (net revenues had been unaffected by the increase in TWB and the tax rate on earnings is now lower). In the two higher wage regions, the increased base would ceteris paribus reduce net transfers, which would then be partially but not wholly offset by the reduced tax rate. In short an increase in TWB will unambiguously transfer resources to R1 workers.

b) The Political Economy of Program Cost Redistribution: Evidence

The impact of the employer equity hypothesis on the state’s choice of TWB is ambiguous theoretically. Intuition suggests that a greater proportion of stable, high wage firms in a state would put downward pressure on the TWB, average wages constant. This is a simple voting power consideration—high-wage, stable firms prefer lower subsidies to unstable firms (a lower TWB) and there are more stable firms. Offsetting the direct political power is an offsetting cost or price consideration.12 For a given generosity of transfer from stable to unstable firms, the cost to any stable firm is less if there are relatively fewer unstable firms.

The impact of the distribution of high wage, stable firms on state TWB is then an empirical question. To explore inequality effects, two measures are added to the standard lnTWB model:

- FIRM500+, the percentage of a state’s employment that is in firms of 500 employees or more;
- GINI HH INCOME, the gini index of the inequality of income in the state.

Slightly over half (51%) of all employees in the United States were employed in firms of 500+ workers in 2011, with a range of 32% (Montana) to 59% (Nevada), SBA (2015). The Gini distribution ranges between 0 (complete equality) to 1 (all income received by one person).

12 See Parsons (1982) for a discussion of this same ambiguity in predicting the consequences of a greater aged population on the generosity of state provision of Old Age Assistance (OAA), the first Federal welfare program.
In the United States in 2014, the Gini for the U.S. was 0.480 and the range 0.418 (Alaska) to 0.522 (District of Columbia), U.S. Bureau of the Census (2014).

In Table 3, the two variables are introduced into the basic model, first individually, Columns 1 and 2, and then together, Column 3. Both variables have a negative impact on State TWB as one would expect if the voting power effect dominates the cost (price)-reduction effect on transfers to less stable firms. The income distribution effect is the substantially stronger of the two, both in the adjusted $R^2$ when introduced individually and in statistical significance of the coefficient when entered jointly. A greater share of stable, high-wage firms depresses a state’s TWB.

VI. The Federal TWB: Policy Thoughts

The thirty-five year Federal minimum TWB freeze has provided the states with the freedom to craft TWBs to local labor market conditions. The response by the states has been to align UI program TWBs to the distribution of wages in the state. States apparently balance the competing pressures from high-turnover (low wage) firms and low-turnover (high wage) firms to transfer program costs to the other, and a TWB that adjusts to state payroll wages, then maintains an equilibrium. The implicit reversion of TWB policies to the states simply extended the basic notion of intertemporal matching of TWB to wages to one of locational matching.

The potential social gains are obvious. Imagine, not implausibly, that there is an optimal level of transfers from stable firms to unstable firms, perhaps zero. The gains to eliminating transfers from stable to unstable firms would seem transparent. The impact of an effective Federal minimum TWB on what is essentially 51 local markets is obvious and intuitively unappealing. The impact on high wage states will be minimal or even zero if the states prefer to set a TWB above the new, higher Federal TWB standard, which is of course

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13 Schwabish (2008) provides a detailed review of the somewhat inconclusive evidence on inequality effects on state spending patterns.
a minimum. A higher Federal minimum will force stable employers in low wage states to make additional transfers to unstable firms and industries.

There is evidence of the redistributational impact of a large increase in the Federal minimum wage. Anderson and Meyer (2006) estimate the impact of a sharp increase in the Federal minimum TWB on the distribution of UI payroll taxes across worker income levels, considering the two equity principles highlighted by Becker (1981): (i) the “ability to pay” (taxes only) and (ii) benefits received (taxes less benefits). In particular they simulated the distribution of the payroll tax burden in response to an increase in the TWB from current level to the level of the Social Security maximum taxable earnings. Although the Social Security maximum tax of $60,600 (at the time) is perhaps of no direct relevance to UI, the simulation can be viewed as assessing the impact of a substantial increase in the UI TWB. Estimates are for 1994 and are drawn from the 1993 SIPP panel dataset.

It is almost tautological that a low TWB will place the heaviest tax burden on low wage workers (the tax is regressive), and that is indeed the case in the Anderson and Meyer simulations, Figure 6 Panel A. The current distribution of taxes, denoted by the solid line, is sharply skewed toward low wage workers. Increasing the TWB dramatically, from each state’s TWB to a uniform TWB at the SS maximum level while reducing the tax rate to make the change revenue neutral, largely eliminates the regressivity; see the dashed line, The tax burden distributed roughly proportionally across wage deciles.

<figure 6>

More interesting is the redistribution under the insurance principle, the impact of an increase in the TWB on taxes net of benefits by wage decile, illustrated in Figure 6B. The calculations reveal that the current level of TWB is almost neutral in its equity effect under the insurance principle. The large increase in the TWB does indeed shift the burden of financing the system toward the high wage workers (employers)—the insurance premium is “unfair” to stable employers.

14 The results here are based on wage rate deciles, but they also report the redistribution based on individual and household income.
A Federal override of State decisions could be justified if there is an externality across states that required remedy. An assumption underpinning the entire Federal UI program, for example, is that workers do not value the program at cost—though they should—so that unfettered competition across states for business would induce states to limit unemployment insurance or perhaps offer none at all. However, the negative effects of interstate competition in TWB are difficult to imagine. That California and Arizona have not expanded their TWB beyond the statutory minimum would not seem to bestow (or forfeit) a competitive advantage on those states relative to say Washington and Hawaii, which have TWBs six times higher. Neither can one presume that it reveals a level of state planning incompetence that requires direct Federal management of the program. California and Arizona as governments have operated UI tax systems for decades that are the equivalent of a lump sum tax with the corresponding redistribution across employers that this TWB implies. There seems little reason to question these long-standing state choices.

It would appear that critics of the current Federal TWB policy failed only in their policy target, focusing on the Federal minimum TWB, which of course represses the ability of states to align TWB with wages. In the absence of any obvious externalities, the calls of experts to align the TWB with wages makes reversion of TWB decisions to the states good policy. Or as Joseph Becker (1981, 125) argued, the Federal tax base should be kept as low as possible. “When the federal government raises the federal tax base, it imposes on the states a requirement unadjusted to state differences and innocent of state history.” (181, 124).

**VIII. Conclusion**

Experts have repeatedly expressed concerns about the low Federal TWB, a lament logically linked to an appeal to raise the TWB and to index it to future wage growth. What analysts overlooked, however, is that the Federal TWB is only a statutory minimum for state TWB levels. Freezing the minimum TWB permitted the individual states to tailor their UI financing program to their own labor markets.
The elimination of an effective minimum TWB permits analysis of the political economy of this policy tool. State TWB adjustments to the large (UI) financing shocks of the 2007-2008 recession reveal that TWBs changed substantially only in states with especially large expenditure shocks, with the tax rate (TAX/TWB) absorbing short-term budget pressures. As critics of the Federal TWB freeze would find reassuring, state TWBs vary systematically (and positively) with average payroll wages. Indeed the TWB/WAGE ratio within states has been surprisingly stable for decades, suggesting that it is not simply a neglected, minoe policy tool.

Recent critics of the Federal TWB freeze ignored the large state differences in labor markets and framed the TWB discussion as a simple tax (only) question. A flat tax with an upper bound is by definition regressive, the more so the further the TWB falls behind wage growth. The underlying political economy issue would then be over tax progressivity, with the expectation that cross-state variation in TWB would be driven by political leanings as well as wage levels. The hypothesis that more progressive states choose less regressive (higher) TWBs is rejected by the data.

An earlier generation of UI policy analysts had developed and provided evidence for a richer measure of gains and losses in TWB setting built around the primary financial unit, the employer. Low-wage firms and industries are systematically high turnover (high unemployment) firms and industries. If experience rating is incomplete, then a critical conflict is between low cost, low turnover (high wage) firms and high cost, high turnover, low wage employers. A higher TWB makes insurance “premiums” of low cost employers increasingly unfair. Earlier analysts established that variations in TWB have the predicted reallocation effects across firms of different turnover characteristics, and that owner/mangers frame the policy dispute in this light. A cross state analysis of TWB reveals that states with proportionately more large (stable) firms and a greater inequality of income (proportionately more high wage firms) do indeed set lower TWBs.

As George Stigler (1946, p.358) began his post-World War II assessment of minimum wage legislation, “The minimum wage provisions of the Fair Labor Standards act of
1938 have been repealed by inflation.” That would appear both true and less controversial as a policy outcome when applied to the Federal TWB. The “repeal” of the Federal (minimum) taxable wage base by inflation has freed the states to tailor the TWB policy parameter to wages levels in their own labor markets, not to those thousands of miles distant.
REFERENCES


Table 1
Regression Estimates of Economic Determinants of Key UI Finance Features
U.S. States and DC 2014

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The dependent variable is noted at top of column. Standard errors in parentheses. A single asterisk denoted 0.05 level, a double asterisk 0.01.
### Table 2
Regression Estimates of Political Economy Effects on State lnTWBs
Fifty-one U.S. States and DC 2014

<table>
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The dependent variable is the natural log of State TWBs. Standard errors in parentheses. Column 1: No DC. Column 2: no DC nor Nebraska. A single asterisk denotes a 0.05 level of significance for the estimate, a double asterisk 0.01.
### Table 3
Regression Estimates of Inequality Effects on State lnTWB
Fifty-one U.S. States and DC 2014

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<td>$R^2$</td>
<td>0.51</td>
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The dependent variable is the natural log of State TWBs. Standard errors in parentheses. A single asterisk denoted 0.05 level, a double asterisk 0.01.
Figure 1
The Distributions of State Taxable Wage Bases and Tax Rates (TAX/TWB) 2014

PANEL A: Taxable Wage Base

PANEL B Tax Rate (TAX/TWB)
Figure 2
UI Tax Rate (TAX/TWB) vs TWB 2014 By State and DC
Figure 3
Fractional Change in Tax Parameters as Function of Total Contributions per Worker 2008-2014

Panel A: Fractional Change in TWB

Panel B: Fractional Change in Tax Rate (TAX/TWB)
Figure 4
TWB/WAGE Ratio 2014 vs TWB/WAGE Ratio 1994
Fifty States and DC
Figure 5
Taxable Wage Base vs Ave UI Wages, States and DC,


Figure 6
UI Payroll Tax and Net Tax Rates by Income Decile
Before And After Revenue Neutral TWB Increase Anderson And Meyer (2006)

Panel A Tax Only

Panel B Net Tax Rate (Taxes less Benefits)

Source: Author calculations from Anderson and Meyer (2006, Tables 2 (p.82) and 3 (p.86).
Appendix Table 1  
Variable Definitions and Data Sources, Fifty-one U.S. States and DC  
(All 2014 unless otherwise noted)

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<th>Variable</th>
<th>Description</th>
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<td>State average UI contributions (taxes) per worker Author’s construction from US DOLETA (2014).</td>
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<td>State UI tax rate (TAX to TWB ratio) US DOLETA (2014).</td>
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<td>State average UI payroll wages (Author’s construction from US DOLETA (2014).</td>
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<td>State policy liberalism index 2014, Coughly and Warshaw (2016).</td>
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<td>Fraction of state legislators who are Democrat (Average of two chambers) National Conference of State Legislators (2014).</td>
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<td>State union density (percent of wage and salary workers with a union affiliation) BLS (2014).</td>
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<td>Percent of State workers employed in firms with 500 or more employees, Small Business Administration (2015).</td>
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<td>Gini coefficient of State household income distribution (0-1, with 1 denoting complete income inequality—all income earned by one household. U.S. Bureau of Census (2014).</td>
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Appendix Table 2
Means and Standard Deviations

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