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- UI benefit payments have increased during the recession to an unprecedented $468.5 billion
- State UI trust funds may not be solvent for three years or adequate until the end of the decade.
- UI financing could be improved by changing the federal-state financing framework or expanding the federal role.

Financing Unemployment Insurance after the Great Recession

Wayne Vroman

The Great Recession and "Not-So-Great Recovery" have put a tremendous strain on state unemployment insurance systems. Collectively, the states have borrowed over $50 billion to pay unemployment compensation benefits to unemployed workers. Estimates suggest that it will take several years to pay off that debt and almost a decade until states have adequate funds in reserve to respond to future unemployment.[1]

This brief assesses the financing of regular state UI benefits, specifically state financing experiences during and after the Great Recession that commenced December 2007. Sections (1) provide background on the Unemployment Insurance (UI) system; (2) summarize UI system performance in the Great Recession, providing an overview of benefit payment experiences, state borrowing, and the response of the UI tax system that finances regular benefits; (3) analyze causes for the financing problem; and finally, (4) discuss potential remedies to improve fiscal integrity in regular UI, focusing on both state and federal policy action to restore its long-run fiscal solvency.

About Unemployment Insurance

Unemployment Insurance (UI) is a social insurance program in which recession-related increases in unemployment raise UI benefit payments to help stabilize household incomes and the macro economy. Because the response occurs automatically when unemployed workers file for benefits, UI is described as an automatic stabilizer of the economy.

Program financing is provided by employer payroll taxes paid into state UI trust funds held at the U.S. Treasury; these funds are the immediate source for benefit payments to the unemployed. Employer payroll taxes that finance regular UI programs are levied under state systems of experience rating. That is, the state assigns higher UI tax rates to employers that make larger payments to laid off or terminated employees. Recessions increase benefit payouts, which decrease UI trust fund balances. Lower balances in turn prompt an experience rating response that later raises UI taxes to restore

Of the $260.1 billion of regular UI benefits paid from 2007 to 2011, about $85.0 billion was linked to the increase in unemployment.

trust fund balances to pre-recession levels. The net economic stimulus provided by UI during the downturn, when benefit payments exceed taxes, is reversed in the ensuing recovery as tax revenues exceed benefits and trust funds are restored.

Although the preceding description of UI will be familiar to many, it covers just the first tier of the system, or regular UI. (It is also known as unemployment compensation, or UC.) In every recession since 1958, the federal government has provided some form of federal emergency benefits to those who have used up (exhausted) their regular UI benefits, and those additional benefits are fully financed by the federal partner. During the Great Recession the federal program was termed Emergency Unemployment Compensation (EUC).

In addition, the Federal-State Extended Benefits (EB) program was created in the early 1970s to provide regular UI exhaustees with up to 13 additional weeks of benefits. These benefits are financed on a 50-50 basis by the states and the federal government. Taken together, UC, EB, and EUC make up the three tiers of UI benefits. Regardless of their funding source, all tiers are paid to eligible unemployed workers by the state UI agencies.

The response of UI taxes, which should increase in response to a rise in UI claims, has been attenuated following recent recessions. As a consequence, the trust fund balances for many states were low even before the Great Recession. Low balances coupled with the recession's depth and duration resulted in widespread borrowing by state UI programs followed by a slow pace of trust fund restoration during 2010–2012. The aggregate net trust fund balance (state reserves less outstanding loans) across all state UI programs may not return to positive territory for two or three years. Fund balances will not be restored to adequate pre-recession levels until late in this decade at the earliest.

Table 1. Unemployment Insurance Benefit Payments, 2007 to 2011 ($ billions, nominal)

	Regular UI	EUC	EB	FAC	Total
2007	32.4	—	0.0	—	32.4
2008	43.1	7.9	0.0	—	51.0
2009	78.8	42.3	6.0	9.5	136.6
2010	58.6	66.0	9.2	10.3	144.1
2011	47.2	47.2	10.0	—	104.4
Total	260.1	163.4	25.2	19.8	468.5

Source: Office of Unemployment Insurance, U.S. Department of Labor.
Note: Data refer to 51 state programs: the 50 states plus the District of Columbia.
— = not applicable

The Great Recession and UI Trust Funds

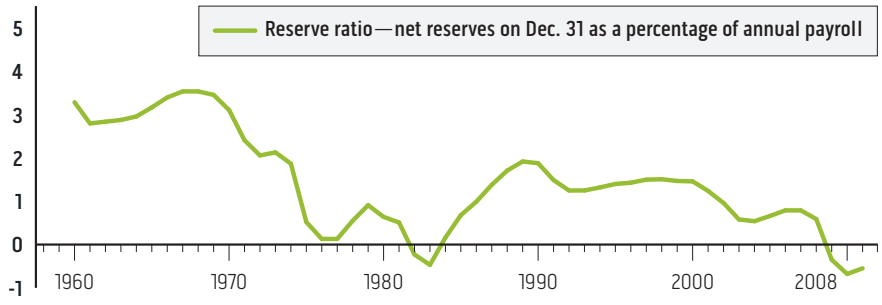
The Great Recession was the most severe economic downturn since World War II. In the labor market, unemployment started to increase in mid-2008 and continued to increase until late 2009. The unemployment rate (or TUR[2]) averaged 9.3 percent of the labor force during 2009, more than double the 4.6 percent of 2007. Unemployment has subsequently remained high, with TURs of 9.6 percent in 2010, 8.9 percent in 2011, and 8.2 percent during the first six months of 2012. The TURs of 2012 exceed the highest TURs of the previous two recessions, 7.5 percent in 1992 and 6.0 percent in 2003.

Recent U.S. labor market weakness is reflected in unprecedented unemployment durations. Average 2009, 2010, and 2011 unemployment durations of 24.0, 33.0, and 39.3 weeks, respectively, have substantially exceeded the previous maximum of 20.0 weeks from 1983. The maximum duration in 2011 was nearly twice the maximum from 1983.

High and persistent unemployment has been met by an unprecedented increase in benefit payments from the three tiers of the UI system. Table 1 summarizes annual UI benefit payments in 2007 to 2011 for each tier and for a special $25 addition to weekly benefits, termed Federal Additional Compensation (FAC), paid to all recipients during 2009 and 2010. Total benefit payments for the five years were $468.5 billion. Of this total, $208.4 billion was paid by EUC, EB, and FAC. Since EUC and EB are still active this year (mainly during the early months), they continue support the unemployed along with regular UI.

Note in table 1 that payments of regular UI in 2009 were more than double those of 2007 ($78.8 versus $32.4 billion), indicating the size of its automatic response to the recession. Regular UI is a permanent program that pays benefits in all years. A crude projection of payments from 2007 to 2011 suggests that of the $260.1 billion of regular UI benefits paid during these five years, about $85.0 billion was linked to the increase in unemployment while about $175 billion would have been paid with unchanged unemployment.[3] In contrast, payments of EUC, EB, and FAC reflect policies that expanded benefit availability during the Great Recession. The scale

Figure 1. UI Program Reserve Ratio 1960 to 2011



Source: Office of Unemployment Insurance, "Unemployment Insurance Financial Data, Handbook 394" and updates, 2012.

of these additional benefits was unprecedented. During both 2010 and 2011 extended benefits combined exceeded regular UI benefits, the first time in program history.

While increased UI benefit payments have strongly supported the unemployed and the macro economy, the increased regular UI benefit payments have severely depleted state UI trust funds and have caused most states to borrow to sustain benefit payments. Since 2008, 35 of the 51 state systems (the 50 states plus the District of Columbia) borrowed from the U.S. Treasury, and loans totaled more than $50 billion.[4] At the end of December 2011, 28 states had outstanding Treasury loans that totaled about $42 billion. Following the receipt of first-quarter tax accruals during April and May 2012, 23 states had outstanding Treasury loans totaling about $30 billion. Additionally, three states have borrowed in the private securities market and owe roughly a combined $5 billion. Because interest rates in private markets are lower than the rates on Treasury loans, other states are likely to pursue this option during 2012.[5] Most state UI trust funds in 2012 remain severely depleted.

Figure 1 summarizes national developments in state UI reserves from 1960 to 2011 by depicting end-of-year reserve ratios, that is, net reserves as a percentage of annual payroll. In addition to the long-run downtrend in the reserve ratio, note that net reserves were negative for two years in the mid-1980s. They were again negative the past three years and will remain negative for two, possibly three, more years. The current negative reserve situation is unprecedented in the entire 77-year history of state UI programs.

Since 2011, states with loans from the Treasury outstanding for two or more years have been paying annual interest, 4.09 percent in 2011 and 2.94 percent in 2012. Additionally, debts outstanding for more than two years are subject to mandatory repayments through increases in UI taxes levied by the federal partner. During 2011, 23 states paid higher federal UI taxes starting at 0.3 percent of federal UI taxable wages in the first year, but then growing each year the loan balance remains unpaid. To avoid these borrowing costs, states have strong incentives to repay their Treasury loans.

Aspects of the State UI Financing Problem

The most common measure of trust fund adequacy is termed the reserve ratio multiple (or RRM). The RRM is a ratio of two ratios. The numerator ratio is the aforementioned reserve ratio (the ratio of trust fund reserves to annual covered payroll expressed as a percentage).[6] Note that the reserve ratio scales each state's reserves to the size of the state's economy as reflected in its total payroll. The denominator ratio is the highest past payout rate (that is, benefit payments as a percentage of covered payroll) during 12 consecutive months measured over the entire past history of the state's program. States with higher RRMs are judged to have more solvent UI trust funds. It is often recommended that a state UI program achieve an RRM of 1.0, meaning it has reserves equivalent to 12 months of benefits measured at the highest past annual payout rate. In practice, most states have operated with RRMs substantially below 1.0. At the end of 2007, the simple average of 51 state RRMs was 0.54 (implying 6.5 months of reserves).

Two obvious and systematic patterns can be noted in state RRMs before the Great Recession. First, the 16 states with indexed[7] taxable wage bases (that is, with taxable UI payroll set to automatically increase as wages grow) had much higher average reserves than the 35 nonindexed states. The simple averages of the RRMs for the two groups of states at the end of 2007 were 0.83 and 0.41, respectively. On average, the indexed programs had roughly twice the reserves of the nonindexed programs. Second, the larger states had much lower RRMs than other states.[8] The simple average RRM for the 13 largest states at the end of 2007 was 0.24, much less than half the average of 0.64 for the other 38 states.

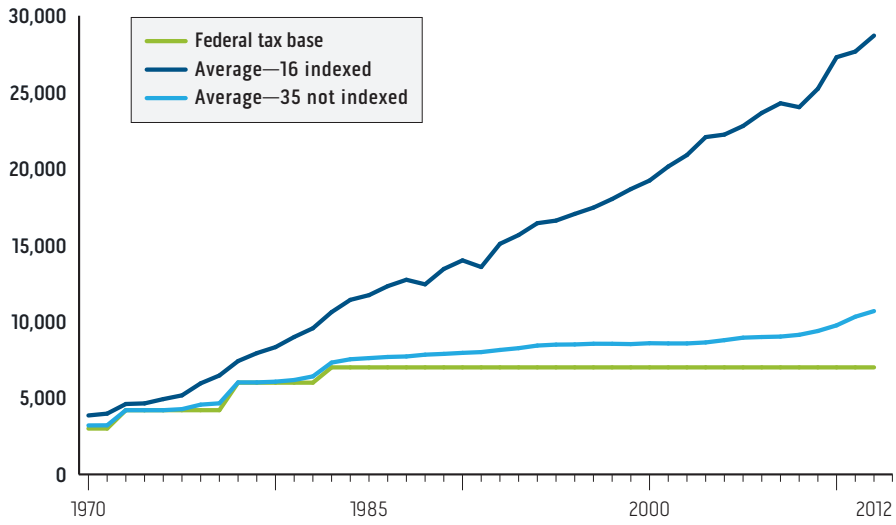
Figure 2 summarizes the evolution of the taxable wage base in both indexed and nonindexed states from 1970 to 2012. The figure also shows the federal taxable wage base, which has

been unchanged at $7,000 per worker since 1983. Averages for both groups of states are simple averages. The average for the indexed states has increased along with the growth in average wages, reaching $28,700 in 2012. In contrast, the average for nonindexed states in 2012 was just $10,682, less than $4,000 above the federal tax base of $7,000. Although nonindexed states could increase their tax bases through state legislation, they have been reluctant to enact large changes.

Recent financing problems in the regular UI programs have been most obvious in the largest states: all 13 have borrowed from the Treasury. While the largest states accounted for 61 percent of covered employment in 2010, their debts accounted for 78 percent of the national total at the end of 2011. Despite entering the Great Recession with low reserves, the same states have had smaller revenue growth during 2010 and 2011 (relative to 2007) than the national average. On average, their debts are larger and may last longer than those of other states. Of the 35 states that borrowed from the Treasury sometime in the past three years, 12 had fully repaid their loans by the end of May 2012. Of the 13 largest states, however, only Massachusetts and Virginia were debt-free on that date.[9] The largest states seem likely to be among the last to fully repay their UI loans.

As might be expected in a financing system with more than 50 jurisdictions, the states have responded in a variety of ways to the Great Recession and its attendant financing challenges. In 2009, when the scale of the downturn became apparent, some states acted quickly to avoid indebtedness and to limit borrowing. States such as Maryland, New Hampshire, South Dakota, Tennessee, and West Virginia did not borrow or secured only small loans. Their response centered on tax increases far exceeding the national average. While the national ratios of UI taxes in 2009, 2010, and 2011 to 2007 were 0.89, 1.13, and 1.41, respectively, the corresponding ratios for these five states were 1.36, 1.99, and 2.29, respectively. Already in 2010 these states' taxes were double those of 2007, while the national increase was only 13 percent. An activist policy response was common to these states, enabling them to avoid the large, prolonged debts of the biggest states.

Figure 2. State and Federal UI Tax Bases 1970 to 2012



Source: Office of Unemployment Insurance, "Unemployment Insurance Financial Data, Handbook 394" and updates, 2012.

Revenues in the biggest states during 2010 and 2011 responded sluggishly against a national background of high corporate profits. As a share of GDP, 2010 and 2011 profits were at their highest levels of the past 65 years.[10] Four large states (Florida, Illinois, Michigan, and Pennsylvania) reduced regular UI benefits during the 2011 legislative sessions, and Georgia followed suit in 2012. The reductions will help lessen future trust fund outflows, but one can question the timing, as unemployment rates have remained high.

Some Possible Policy Directions

How should regular UI program financing be improved to prevent a recurrence of the past five years' large-scale borrowing? Given its present volume, widespread state indebtedness will persist for many more years. Although several states have large debts, several have also navigated the Great Recession without borrowing or needing only small loans that were quickly repaid. Because the situations of the individual states are so diverse, appropriate policy recommendations must recognize this diversity. Any policy that offers partial debt forgiveness must entail a quid pro quo from debtor states that will substantially improve future solvency. To avoid an adverse behavioral response among nondebtor states, recognition and reward for their actions should also be part of a comprehensive package.

This brief discusses two distinct approaches to improve future solvency: (1) changes within the present federal-state financing framework and (2) changes that expand the federal role in UI financing. Because incremental change within the pres-

ent financing framework seems the more likely of the two, most of the discussion will address the first approach.

Restoring Solvency within the Present Financing System

The standard description of UI program financing given at the start of the paper emphasizes the role of experience rating in raising UI taxes and restoring trust fund balances following recessions. Will debtor states restore their trust funds through their own efforts? Based on actions taken in 2010, 2011, and early 2012, the answer may be no. Few states with large debts have acted decisively to reduce their debts. Aggregate net reserves on May 31, 2012, the monthly seasonal peak in most years, were -$16.9 billion, an improvement of just $8.2 billion over May 2011. At the current pace, the states may need three more years just to bring net reserves up to zero, much less to build substantial positive balances.

To reduce state indebtedness and improve long-run solvency, several state and federal actions within the present financing framework can be suggested. The states presently have the authority to make painful but necessary solvency adjustments. The federal partner can institute actions that provide states with financial incentives to undertake solvency-enhancing actions.

One restorative action is for states to allow experience rating to operate as stipulated in state statutes. During 2011 and 2012, at least seven large debtor states enacted laws to reduce UI taxes,[11] despite the unprecedented profits realized by employers. To hasten trust fund restoration, these tax reductions should be ended.

A second restorative state action would be to raise the taxable wage base. As noted in a related analysis,[12] several states have higher tax bases in 2012 than in 2007. However, among the 13 largest states, all needing trust fund loans since 2008, 8 have the same tax base in 2012 as in 2007 while the other 5 have instituted only modest increases. In fact, 9 of the 11 biggest nonindexed states[13] have a tax base below $10,000 in 2012. Reluctance to raise the tax base has been widespread despite large UI trust fund debts.

All regular state UI programs operated with a maximum duration of 26 or more weeks in every year between 1970 and 2010. During 2011, however, six states reduced the maximum duration of regular UI benefits below 26 weeks.[14] These and other recent benefit reductions will curtail future regular UI benefits and lessen their automatic stabilizing effect.

The federal partner may have to provide incentives for debtor states to raise tax revenue substantially and not reduce regular UI benefits. Federal legislation to improve state solvency was introduced but not enacted during 2011. Senators Durbin, Reed, and Brown sponsored the Unemployment Insurance Solvency Act of 2011 (Senate bill S.386.IS), with two features designed to improve UI trust fund solvency. First, the bill provided states with financial rewards if they increased revenues enough to fully repay their trust fund loans and build a large reserve within seven years. Second, it proposed to increase the base for the federal UI tax from its current $7,000 per covered worker per year to $15,000 by 2014. While neither change was enacted during 2011, both would have improved debtor state solvency.

For states that improve solvency over the subsequent seven years, the Durbin, Reed, and Brown bill would forgive a share of their UI trust fund debts in seven equal annual installments. To be deemed acceptable, a debtor state's principal abatement plan must maintain the benefit provisions of its current UI law.[15] This requirement means that improved solvency would be totally due to increased UI taxes. Each state would determine the form of its tax increases, but one requirement would be to increase the taxable wage base to at least $15,000 by 2014 and tie its subsequent growth to growth in average wages. Acceptable principal abatement plans must improve solvency sufficiently to reach an RRM of at least 1.0 seven years after the bill's enactment. For states that enact acceptable plans, the principle on their outstanding debt would be reduced proportionately by 0.2, 0.4, or 0.6, depending on the increase in the state's unemployment rate between 2007 and 2009. States whose unemployment rates increased by 3.5 percentage points or more would be eligible for a 60 percent reduction in their loans. One analysis of these provisions[16] concluded that the states would have to increase taxes significantly to become eligible for partial debt forgiveness.

To ensure that nonborrowing states would also have stake in maintaining solvency under the Durbin, Reed, and Brown bill, they would receive higher interest yields on trust fund balances that exceed specified

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thresholds. This financial reward for prudent trust fund management would be larger for states with higher RRMs.

Because this proposal would raise the federal UI tax base from its current $7,000 to $15,000 in 2014, federal unemployment taxes would increase substantially unless the federal tax rate were also reduced from its current 0.6 percent of federal taxable wages. The proposal would reduce the federal UI tax rate to make the change in the federal UI taxes roughly revenue neutral. The proposal was not enacted during 2011 nor was it reintroduced during 2012.

Will the states be willing to increase taxes by enough to restore solvency in the foreseeable future? Given widespread reluctance of states to increase taxes, it seems plausible that states will not increase revenue by enough to restore fund balances to levels suggested by the RRM solvency standard. It also seems that the financial debt relief incentives offered by the Durbin, Reed, and Brown proposal may be too small to exert much influence on state behavior.

A Larger Federal Role in UI Financing?

With several states exhibiting strong reluctance to increase UI taxes, is it time to remove from the states some or all responsibility for determining regular UI taxes? At one extreme, the federal government could fully take over UI taxes. Decisions about the tax base, the minimum and maximum rates, and the method for setting rates for individual employers (experience rating) could all be discharged by the federal partner. A second approach would have the federal partner establish annual revenue and fund balance targets for each state, but leave it to the states to set the tax base, minimum and maximum rates, and degree of experience rating applied to individual employers. The states would retain control over several aspects of UI taxes but be subject to federal requirements regarding total tax revenue and minimum trust fund balances.

A third approach would impose a temporary federal takeover of financing decisions in states with a history of UI funding problems. The UI programs in problem states, in other words, would be placed in receivership for a finite period until their trust fund were restored to a level deemed prudent by the federal partner. One variant of this approach would be to deny FUTA tax credit offsets to "problem" states. A denial would cause the FUTA tax rate to increase from its current 0.6 percent of federal taxable wages (or higher when loans have been outstanding for more than two years) to 6.0 percent. Under the third approach, the states with a clear record of prudent fiscal stewardship would continue to operate their UI tax systems as at present.

With just two exceptions (the United States and China), the UI programs in all other countries operate with full central government responsibility for program financing. Financing details differ widely with respect to tax rates, employee contributions, the level of the tax base, and indexation of the tax base. But employers and workers in all regions are subject to a national UI law.[17] If the federal government were to assume greater responsibility for UI program financing the United States would be more closely aligned with foreign programs.

All three approaches discussed above would remove some or all taxation decisions from the states due to some states' unwillingness or inability to set tax rates appropriate for the volume of regular UI benefit payments. Any of the three approaches would radically alter the present system of UI financing. Under a U.S. system with increased federal taxing authority, the tax base in each state could be unlimited or limited, and the average effective tax rate variable or fixed from one year to the next. No foreign UI system utilizes experience rating, but that should not prevent a form of experience rating from continuing to be used here.

The most radical proposal, the first alternative, would entail a full federal takeover of UI financing. This would remove all taxation authority from the states regardless of past performance in maintaining their UI trust funds. Experience rating might or might not be retained in such a federalized financing system. Opposition to this proposal would probably be stronger than to the other two approaches outlined above.

These potential solutions may gain increased support if net negative trust fund reserves extend further into the future, especially in the biggest states. Support is also likely to grow if the states continue the 2011 legislative pattern of reducing benefits to improve long-run solvency. Serious discussions of more radical approaches will likely commence only after more years of small state tax responses are observed or a clear pattern emerges of states increasing their reliance on benefit reductions to improve solvency. Since most 2012 state UI legislation has been completed, new information on state financing decisions will not become available until next year. UI legislative developments in 2013 will likely be influenced by both the state and national November 2012 elections. ▪

Notes

1. Wayne Vroman, "The Challenge Facing the UI Financing System," Unemployment and Recovery Project working paper 3 (Washington, DC: The Urban Institute, 2012).
2. The TUR is shorthand for the total unemployment rate, the number unemployed as measured in the monthly labor force survey and expressed as a percentage of the labor force aged 16 and older.
3. The no-recession projection assumed that the $32.4 billion paid in 2007 would have increased by 4 percent in each of the next four years.
4. The UI programs in Puerto Rico and the Virgin Islands are not included in this narrative. The Virgin Islands' program has also borrowed from the Treasury.
5. Illinois has already authorized loans of $2.4 billion, and Colorado and Pennsylvania are considering this option.
6. The national ratio was displayed above as figure 1.
7. These states set their annual tax base to the lagged level of average statewide earnings. The tax base grows automatically as average earnings increase.
8. Of the 13 most populous states, 11 were not indexed and 2 had indexed tax bases.
9. By May 2012, Michigan and Texas did not have loans from the Treasury, but both had municipal bond debts.
10. Namely, profit shares of 0.124 and 0.129 in 2010 and 2011 compared to a 1989–2011 average of 0.095. Between 1947 and 2011, profits as a share of GDP reached 0.120 only six times: 1950, 1951, 1965, 2006, 2010, and 2011. The profit shares in 2010 (0.124) and 2011 (0.129) were the highest of the entire 65-year period. To the extent that profits influence ability to pay, U.S. businesses have been especially profitable during 2010 and 2011.
11. Florida, Massachusetts, Michigan, New Jersey, Ohio, Pennsylvania, and Texas.
12. Vroman (2012).
13. Only New Jersey and North Carolina among the 13 have indexed tax bases. Details of financing adjustments in the 13 largest states are given in Annex A of Vroman (2012).
14. Six states with a maximum duration below 26 weeks in 2012 are Arkansas, Florida, Illinois, Michigan, Missouri, and South Carolina. Georgia reduced its maximum duration below 26 weeks during its 2012 legislative session.
15. This is specified to mean four things: (1) no change in the calculation that would reduce the weekly benefit amount (WBA), (2) no restriction on UI eligibility, (3) no reduction in the maximum weekly benefit, and (4) no other change that effectively reduces UI benefits relative to current law.
16. Vroman (2012).
17. See Annex B in ibid.

About the Author

Wayne Vroman is a senior fellow in the Urban Institute's Center on Labor, Human Services, and Population. The National Academy of Social Insurance has recognized Dr. Vroman as a distinguished honoree for his research in unemployment insurance.

Unemployment and Recovery Project

This brief is part of the Unemployment and Recovery project, an Urban Institute initiative to assess unemployment's effect on individuals, families, and communities; gauge government policies' effectiveness; and recommend policy changes to boost job creation, improve workers' job prospects, and support out-of-work Americans.

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