Unemployment Insurance: Current Situation and Potential Reforms

by

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Introduction

Entering 2009, the American economy faces numerous uncertainties in the product market, the financial market, and the labor market. Aggregate demand has decreased, with a real GDP falloff in the fourth quarter of 3.8 percent. The economy has been in recession for more than a year, and the prospects for 2009 and 2010 are shaky at best.

This short report summarizes the present situation with emphasis on the challenges facing the unemployment insurance (UI) program. It reviews benefit recipiency, state trust fund balances, and administrative performance. Finally, it recommends changes to improve program financing and performance as an automatic stabilizer of family income and the macro economy.

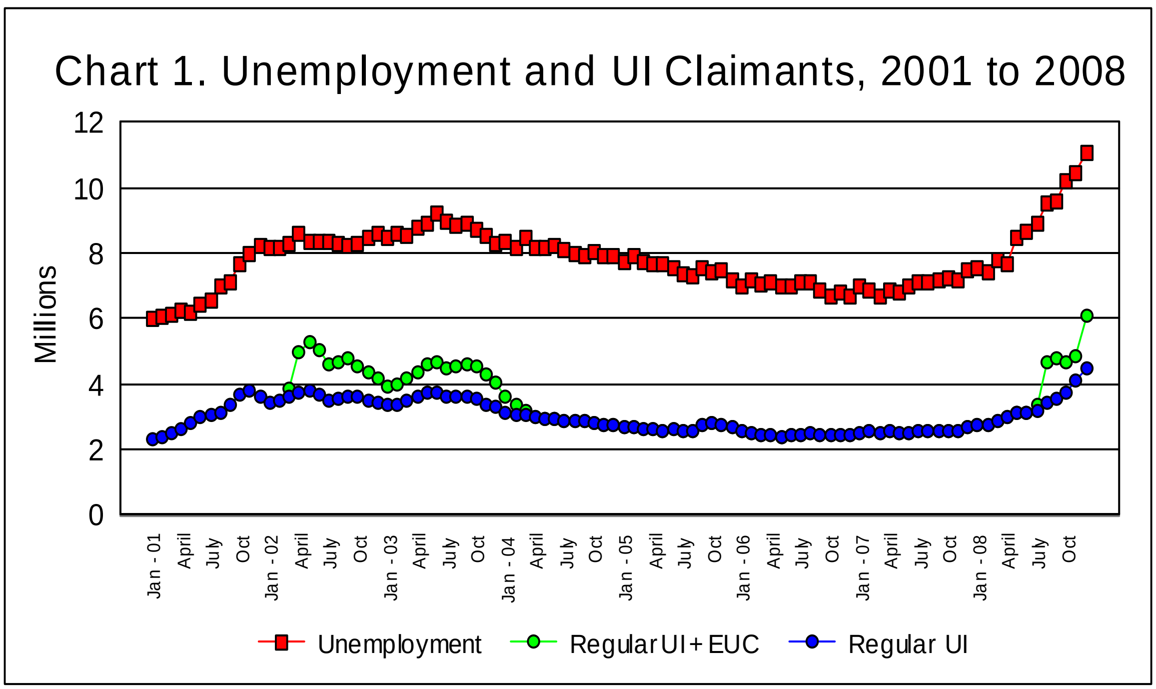
A Review of 2008

Real output (GDP) growth deteriorated noticeably in the second half of 2008. In the labor market, employment losses which had been modest during the first months of the year increased after April. Between December 2007 and December 2008, total employment as measured in the household survey decreased by 2.96 million while unemployment for the same period increased by 3.57 million. Total unemployment in December 2008 stood at 11.11 million, its highest level since 1983, and the unemployment rate of 7.2 percent was the highest since January 1993. Between May and December 2008, the deterioration in labor market performance was especially noticeable.

As in past recessions, the increase in unemployment caused an automatic increase in the number of persons filing for and receiving benefits from state UI programs. Recipients of so-called regular UI benefits (the program that pays benefits up to 26 weeks in nearly all states) increased from 3.1 million in May-June to 4.5 million in December. An added 1.6 million received Extended Unemployment Compensation (EUC) during December. Recipients of regular UI and EUC represented 55 percent of the unemployed during the month.

Chart 1 displays monthly unemployment and UI beneficiaries for the years 2001 to 2008—that is, from before the 2001 recession through the end of 2008. Note the similar patterns of UI benefit receipt during the two recessions. Increased unemployment during both periods is apparent, but the increases during 2008 have been larger. Since uncertainty attends present developments, the full extent of the increase in unemployment will undoubtedly exceed the increase shown in chart 1.

As unemployment rose in both recessions, the number of regular UI recipients also increased. An emergency federal benefit program was present from 2002 through 2003 (Temporary Extended Unemployment Compensation or TEUC) as well as in 2008. Note that in August and December 2008 the number of EUC recipients exceeded 1.2 million, respectively the initial months of EUC and its extension in November. Beneficiaries during August and December included substantial numbers who previously had exhausted UI benefits and experienced a break in benefit recipiency. A similar pattern of high recipiency in the initial months of TEUC is observed during April-May 2002.



Source: Unemployment from the Bureau of Labor Statistics. Regular UI and EUC beneficiaries from the Office of Workforce Security (OWS). Data are seasonally adjusted in millions.

Chart 1 vividly shows the gap between total unemployment and the number of UI beneficiaries. During most years, program beneficiaries average some 35 to 40 percent of all unemployed persons. Nonrecipients include persons ineligible due to inadequate past work experience, those disqualified for reasons related to their job separations (most who quit and many who were discharged), benefit exhaustees, and a variety of other factors. Survey responses by nonrecipients indicate the most important reasons for nonreceipt are perceived ineligibility due to lack of work experience and the circumstances of the job separation. Chart 1 also vividly shows that UI recipiency increases in recessions when unemployment rises. Nevertheless, recipiency in the United States is low when compared to most other developed economies,[1] and recipiency exhibits wide variation across states and regions. Unemployed persons in the Northeast and Pacific coast are about twice as likely to receive UI benefits as persons who reside in the South and in the Rocky Mountain states.

Advocates for claimants and researchers have identified key policy initiatives that would increase UI recipiency. Enactment of the proposed changes would enhance the performance of UI as an automatic stabilizer of both the macroeconomy and family income. Three areas for potential changes are the following: (1) Establish an alternative base period (ABP) to allow more recent claimant earnings to be credited in determining eligibility. About 20 states currently have an ABP. It improves eligibility among workers with low wages and those with variable hours worked. (2) Allow unemployed part-time workers to be eligible if searching for work at hours comparable to hours worked in the past. Currently about half the states allow only persons seeking full-time work to be eligible for UI. (3) Allow a broader range of quits to be potentially compensable. The expanded reasons could include quits to care for a sick family member or quits to follow a spouse whose job has been transferred.[2] The economic stimulus bill recently passed by the House of Representatives would enhance eligibility along these lines as well as enhancing weekly UI benefits. This is briefly discussed below.

The Unemployment Insurance Trust Funds

[1] Among 20 high-income European and English-speaking member countries of the Organisation for Economic Co-operation and Development (OECD), U.S. recipiency from 2000 through 2004 averaged 0.39 compared with a median of 0.87. Only Greece had a lower recipiency rate than the United States.

[2] To be eligible for UI benefits, the claimant must be able and available for work. Eligibility in these situations would be allowed after the episode of care giving and after the geographic relocation.

The states finance UI benefits with payroll taxes paid by employers into state trust funds maintained at the U.S. Treasury. State balances earn interest income. The Treasury also makes loans to states whose trust funds have been exhausted. At the end of 2008, trust fund balances were low in several states, and three (Indiana, Michigan, and South Carolina) had already borrowed to maintain benefit payments to eligible workers. During December, four other states also requested and received authorizations to borrow from the Treasury (California, Kentucky, New York, and Ohio). All four of these states borrowed from the Treasury during January 2009 and combined end-of-month indebtedness for the seven programs totaled $2.1 billion. Depending upon the severity of the recession, some 10 to 20 states will have to borrow during 2009. The present trust fund situation is the most serious faced by the states since the early 1980s.

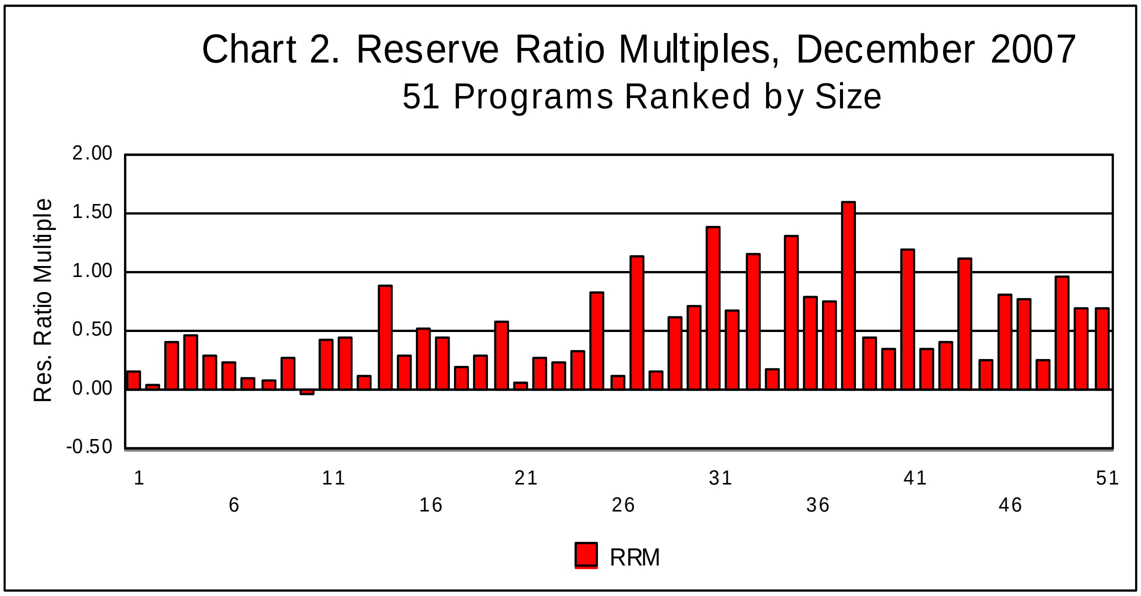
A common measure of UI trust fund adequacy is the reserve ratio multiple (RRM), also termed the high cost multiple. The numerator of the RRM is the reserve ratio, the ratio of the trust balance to total payroll of covered employers (measured as a percentage). The denominator is the highest-ever 12-month benefit payout rate previously experienced (also a percentage). The recommended standard for solvency is that the pre-recession RRM equal 1.0, e.g., the fund hold twelve months of reserves measured at the high-cost payout rate. For the aggregate U.S. economy, the highest-ever payout rate was 2.22 percent of payroll experienced during January-December 1982. Before the current recession, reserves across 51 state UI programs totaled $37.6 billion in December 2007 and represented just 0.80 percent of total payroll for the year.[3] The RRM at the end of 2007 was 0.36, that is, the reserve ratio of 0.80 percent divided by the high cost rate of 2.22 percent. Reserves totaled about a third of the recommended actuarial standard and represented roughly four months of benefits at the highest-ever payout rate. The aggregate RRM at the end of 2007 was lower than prior to any recession since the late 1970s. Because reserves recovered only partially following the recession of 2001, they were $16.5 billion lower at the end of 2007 than at the end of 2000.

The UI program during 2008 witnessed a further loss of reserves as claims increased, especially in the last half of the year. Aggregate reserves on December 31st

[3] There are 53 "state" programs. Puerto Rico and the Virgin Islands are excluded from this total but the District of Columbia is included.

reached $28.5 billion, a loss of $9.1 billion during the year. The low reserve position is particularly acute for the largest states. As a group, the largest states have generally low taxable wage bases, and this has inhibited the growth of reserves in recent years.

Chart 2 illustrates the situation of the big states at the end of 2007. The chart shows RRMs for 51 programs ranked by size. States in the chart were ranked using total payroll in 2007. Not one of the top 25 states had an RRM of 1.0 at the end of 2007. Chart 2 further shows that RRMs fell below 0.50 for all but three of the 25 largest states. Many, perhaps a majority, of the large states will have to borrow from the Treasury before the present downturn runs its course. Large states, states in the Midwest, and states with low UI tax bases are at risk of needing the largest loans.



Source: Data from OWS. States ranked by total payroll in 2007.

One favorable factor in the financing situation of many individual states has been operating the UI program with an indexed taxable wage base, that is, a tax base that increases automatically with increases in the average wages of covered workers. At the end of 2007, for example, the indexed programs accounted for just 4 of the 30 programs with an RRM below 0.50 but five of the seven programs with an RRM of 1.0 or higher. Reserve adequacy has been preserved more effectively in states with UI tax bases that increase automatically with earnings growth.

States needing loans to pay UI benefits can borrow in a number of ways. The traditional source is the Treasury. Loans taken during the first nine months of the year do not carry interest charges if fully repaid by September 30th and no further borrowing occurs before the end of the year. Longer-term loans carry interest charges with interest rates levied at the same rate as interest paid on positive state trust fund balances at the Treasury. This method of borrowing operates to minimize the average daily balance of the debt. If loans are outstanding for two years, an automatic repayment mechanism is activated that collects added FUTA taxes as long as debts are outstanding using tax rates higher than the standard 0.8 percent levied on FUTA taxable wages.[4] New York repaid much of its borrowing from the 2002–2005 period with increased FUTA taxes.

States' UI programs have also secured loans in the private bond market in recent recessions. Three states used the proceeds from private loans to repay borrowing from the Treasury. Higher payroll taxes were then levied on employers in later years to repay the private loans. Illinois, North Carolina, and Texas borrowed in the private market after the 2001 recession while Connecticut, Louisiana, and West Virginia used private loans in earlier periods. The loans have varied in duration and the terms of repayment. Some states will probably explore this option in 2009 and 2010.

The states that borrow often enact legislation to improve solvency and prevent a recurrence of borrowing in subsequent downturns. Solvency adjustments typically include both tax increases on employers and benefit reductions for claimants. These adjustments add economic hardship for both claimants and employers, hardships that can be avoided if pre-recession trust fund reserves are adequate. Following the recession of 2001, Illinois, Massachusetts, Missouri, and Minnesota all enacted solvency legislation. Solvency legislation is likely in several states during 2009 and 2010.

UI Program Administration

FUTA tax receipts fund the UI administrative activities, the Employment Service (ES), and other labor market services, such as labor market information and services to

[4] These levies are reduced FUTA credit offsets. They are levied at a 0.3 percent rate in the first year and at higher rates in subsequent years.

veterans. Since 1983, the FUTA tax has been levied at a rate of 0.80 percent of covered wages taxable under the FUTA tax base of $7,000 per worker per year. These tax receipts are divided, 80 percent directed into the federal trust fund that finances the administration of UI, ES, and other services (the Employment Security Administration Account or ESAA) while 20 percent flows into the Extended Unemployment Compensation Account (EUCA). The EUCA account pays half the benefit costs of Federal-State Extended Benefits (EB) program and the benefit costs of emergency federal programs, such as the Extended Unemployment Compensation (EUC) program enacted in mid-2008. A third federal UI trust fund, the Federal Unemployment Account (FUA), is available to make loans to states whose accounts at the Treasury have been exhausted. At the end of December 2008, FUA loans were outstanding for three states (Indiana, Michigan, and South Carolina), but four other states also borrowed during January 2009 (California, Kentucky, Now York and Ohio).

Each of the three federal UI trust funds has a statutory ceiling, and when any one reaches its ceiling there are rules that direct excess revenues into the other accounts. When all three trust funds are at their respective ceiling, any excess is to be returned to the states as deposits into their state UI accounts at the Treasury. In the past, federal legislation has disbursed monies to the states when the trust funds were below these ceilings. Most recently, $8.0 billion was disbursed to the states in March 2002. These so-called Reed Act monies were allocated to the states proportionately according to their UI taxable wages. There are proposals for a similar distribution in 2009.[5] At the end of 2008, the combined balances in the three federal UI trust funds totaled $31.3 billion.

Federal financial support for the administration of the UI, ES, and other labor-market programs has not kept pace with the growth in the labor market. Monies to administer these programs roughly matched ESAA taxes in the early 1980s, but now they represent only about 60 percent of ESAA taxes. As a result, states have had to restrict their oversight of continuing claims eligibility and other aspects of claims administration, so-called integrity activities. State support of reemployment activities provided through

[5] A bill sponsored by congressman McDermott would allocate up to $7.0 billion to states that enact extensions of benefit eligibility. The cover organization for UI and ES administrators, the National Association of State Workforce Agencies or NASWA, has recently proposed a $6.0 billion Reed Act distribution to the states for use in benefit payments and UI-ES administrative activities. These bills are discussed below.

the ES programs and the one-stop centers in the states has also been adversely affected. Besides restricting their administrative activities, the states have had to supplement their federal allocations with monies from state sources. In fiscal year 2007, these state monies equaled 10 percent of the combined UI and ES allocations.[6] In the current fiscal environment, many states will be hard pressed to continue this support.

Over the past two decades, UI program administration has undergone profound changes. The image of claimants lined up at UI intake offices is no longer accurate for the vast majority of claimants. During 2007, 87 percent of initial claims and 81 percent of continued claims were filed either by telephone or over the internet. Internet claims are growing each year and their volume now approaches the volume of telephone claims. In-person filings accounted for only 10 percent of initial claims and less than 1 percent of continued claims in 2007.

The transition to current filing arrangements has been under way since the mid-1990s. Thus, prior to the current downturn, the UI program had a single recessionary experience under current filing methods. The recession of 2001 was comparatively mild and current filing methods were only partially in place. Thus, the current recession is the first serious recession to test the ability of UI administration to handle a sharp increase in claims volume. The system is experiencing difficulties in processing the increased claims volume of 2008 and 2009. Adding to administrative problems have been the need to gear up for the initial phase of EUC of August 2008 and the revised EUC of November 2008.

The administration of UI claims operates under requirements for prompt administration. Eligibility determinations and payments are to be made within two weeks of filing for at least 87 percent of initial claims. For in-state claims during the period April 2007 to March 2008, 11 states fell short of this standard. As claims volume increased during the second half of 2008, additional states found it difficult to meet the federal promptness requirements.

Increasing the UI and ES allocations to the states would help the states to improve the administration of labor market programs. Three areas would benefit from enhanced administrative allocations: (1) The oversight of continuing claims eligibility would be

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[6] The sum of federal monies for UI and ES administration in fiscal year 2007 was $3,124 million. State supplementation totaled $346 million or 10.0 percent of the combined total.

improved if the states could devote increased resources to activities such as eligibility reviews, e.g., one-on-one meetings with claimants to discuss reemployment strategies and to improve (automated and other) methods of job search. This would result in reduced claims duration and savings on benefit payouts. (2) Increased reemployment services could be provided by the ES and one-stop centers in the states. (3) An increased volume of IT upgrades for the ongoing activities of UI administration could be supported. The result of such changes would be a more efficient and effective system of income support for the unemployed and improved labor market support services to (unemployed and other) job seekers.

Recommendation to Improve UI Program Performance

State UI programs as currently structured and administered have important limitations that should be remedied. At present (January 2009) there are two proposals to modify UI, the $6.0 billion Reed Act disbursement advocated by NASWA and the McDermott bill to disburse $7.0 billion from the federal trust funds to states that improve (or have already improved) access to benefits. The Obama administration included UI modifications as part of the 2009 economic stimulus package recently passed by the House. While the UI component of the final stimulus package is not certain, it is most likely to include a further extension of EUC benefit duration, perhaps provisions related to state UI trust fund problems and possibly an extension of health insurance coverage for the unemployed.

None of these changes, however, will address the fundamental constraint that limits the ability of UI to effectively perform as an automatic stabilizer. The biggest problem facing state UI programs is inadequate funding. This inadequacy is largely due to the low taxable wage bases present in most states. Low tax bases, in turn, are mainly responsible for the low levels of UI trust funds and low solvency measures such as the RRMs displayed earlier in chart 2. This should be the first and most important of four UI reform recommendations.

(1) Raise and index the FUTA tax base. The most important single policy change to improve UI program financing for the long run is to substantially increase the FUTA

tax base above its present level of $7,000 per covered worker. I recommend the tax base be raised to $20,000 or $25,000. Because states must have a taxable wage base that at least matches the federal FUTA tax base, this single change would increase the potential revenues of nearly all state UI programs. Adopting a FUTA tax base in the $20,000–25,000 range would raise the ratio of taxable payroll to total payroll from its current ratio of 0.25 to about 0.50, similar to its average during the 1970s.

More effective than simply raising the federal tax base would be to index it. This would prevent the erosion of the taxable wage share and revenue-generating capacity in the states as has occurred during the past 25 years. Tying the federal tax base to growth in average wages would maintain balance between UI's revenue-generating capacity and benefit payments in future years.

(2) Provide the states with financial incentives to increase trust fund reserves. Several changes would provide incentives. The following recommendations presume that achieving a trust fund balance with a reserve ratio multiple (RRM) of 1.0 is a desirable goal for states to work toward. Past experience has shown that states with an RRM of 1.0 have practically never needed to borrow. The recommendations are presented as a series of carrots and sticks offered by the federal partner to encourage state-level changes:

- Provide an interest rate bonus for all fund balances that span the RRM range between 0.25 and 0.50. This could be done by adding one percentage point to the interest rate paid by the Treasury on positive state trust fund balances. The aggregate cost for full utilization by the states would be about $250 million in 2009 if all had an RRM of at least 0.50.[7]
- Allow states with large trust fund balances to realize an extra interest yield if they make loans to other states with low balances. Paying an interest rate premium of 1.0 percentage point on such loans might make some states with large balances, such as Mississippi, Kansas, Oregon, and Washington, willing to lend to other states. A federal reinsurance role might also be needed if a creditor state required repayment due to an unexpected drain on its own reserves and a borrower state had a problem in repaying the loan.

[7] The specific details of this suggestion (the selection of the RRM range and the size of the interest rate premium) are less important than the principle of improving the structure of incentives so that states are rewarded for building their trust funds.

- Deny cash flow loans to any state that entered a recession with an RRM below 0.25. This would provide another argument for states to have adequate pre-recession reserves. If a state did not accumulate reserves in a pre-recession period, its recession-related borrowing would become more expensive through immediate interest charges. Had this been in effect at the end of 2007, 12 states would have been ineligible for cash flow loans in the current recession.
- Prevent certain borrowing patterns that can be described as "gaming" the system. Two prohibited situations would be the following. First, prevent states from borrowing in the private bond market and depositing loan proceeds into their UI account at the Treasury and realizing an interest arbitrage gain as Texas did in 2002. Second, prohibit states from borrowing in the private bond market to make indebtedness to the Treasury appear as cash flow loans secured over a series of years as North Carolina did from 2003 to 2005. Cash flow loans should be limited to situations where the full repayment to the Treasury is made by September 30th and no UI-related loans are outstanding during the October-December period of the same year. The prospect of paying interest on Treasury loans has motivated state actions to improve solvency in the past.

(3) Increase access to UI benefits. There have never been federal benefit standards in UI programs. Federal oversight of benefits administration has focused on payment timeliness and accuracy. While regular state UI benefit provisions are similar in some areas—for example, monetary eligibility requirements (generally low), statutory replacement rates (typically between 50 and 60 percent for benefits below the weekly maximum), and maximum potential benefit duration (26 weeks)—other aspects of benefit payments are quite varied. In particular, regular UI recipiency rates are highly varied. They averaged less than 0.20 in five states between 1998 and 2007 but above 0.45 in five states for the same period.[8] The maximum weekly benefit as a ratio to weekly wages also varies widely across states. The McDermott bill proposed in 2008 and the bill passed by the House in late-January 2009 would distribute Reed Act monies to states that provided three specific benefit provisions: an alternative base period, eligibility for part-time

[8] Low recipiency in Colorado, Florida, South Dakota, Texas, and Virginia. High recipiency in Alaska, Connecticut, Massachusetts, New Jersey, and Rhode Island.

workers, and eased voluntary quit provisions. The states with low recipiency typically have none or just one of these provisions. Eligible states could use some of the added Reed Act money, $500 million of the potential $7.0 billion, to support UI administration. If a state did not enact any of these benefit provisions, however, it would not receive Reed Act monies.

(4) Increase federal monies for UI and ES administration. The ESAA component of the FUTA tax currently yields about $6.0 billion per year, while the amount sent to the states for UI and ES administration and other labor market services is some $3.5–3.6 billion. Added administrative monies could be used to enhance UI benefits administration and reemployment services. Since the monies are already collected for these purposes, a larger share should be returned to the states. If additional monies were returned to the states, the UI program would have more effective and accurate benefits administration while ES and one-stop centers would provide more effective reemployment services.

The $6.0 billion Reed Act disbursal to the states proposed by NASWA would allow the monies to be used in three ways: UI administration, ES administration, and UI benefit payments. Based on experiences with the Reed Act distribution of 2002, it seems likely that the distribution would be used to pay regular UI benefits by many states. While this spending would help to support aggregate demand, it would have a very uneven effect on support of UI and ES administration. If the monies from the federal trust funds are to go for enhanced program administration, it would be more effective to directly increase the allocations to the states for these administrative purposes.

Finally, there is the question of timing. Suggesting UI tax increases as well as benefit increases in the current environment may raise questions. However, the need for UI reform seems clear, and prospects for reform may be best in the current situation because the UI program is on everyone’s radar screens. Enhanced state UI programs can be a useful component of an economic stimulus package and now may be the best time to enact the UI reforms suggested above.