NELP

**National
Employment
Law
Project**

Beyond Boom and Bust: Financing Unemployment Insurance in a Changing Economy

**Marc Baldwin, Ph.D.
April 2001**

About the Author

Marc Baldwin works for the Washington State Senate. This report expresses his views alone and no state resources were used in its production. Mr. Baldwin has published extensively on the subject of unemployment insurance, most notably while at the National Commission for Employment Policy (NCEP) and United Auto Workers Research Department. He holds a Ph.D. from MIT where his dissertation focused on the decline in receipt of UI benefits during the 1980s.

Acknowledgments

Table of Contents

Appendices

Figures

Executive Summary

This report is part of a series of studies by the National Employment Law Project (NELP) addressing the current state of unemployment insurance (UI) in America. While most of the NELP studies have focused on eligibility and benefit issues, this report calls attention to the structure and outcome of UI benefits financing at the state level. It is intended to spark interest in improving the functioning of UI finance, highlight opportunities to improve access to benefits, and provide a primer for those who are unfamiliar with the complex world of UI finance. It calls into question the level of preparedness among the states as the US economy shows signs of slowing.

Among the key findings are:

- In 2000, UI taxes as a percentage of total covered wages were lower than any time in the history of the UI system.

- Although the UI system should build reserves during economic expansions and spend them down during recessions, many states have deeply cut taxes and endangered their reserves. Tax cuts and declining tax rates have taken over $47 billion dollars out of the UI system between 1994 and 2000.

- Unemployment insurance taxes peaked at 1.4 percent of wages in 1978, falling to less than half that at .54 percent in 2000.

- Only about 40 percent of the unemployed receive UI benefits in the United States. A combination of expanded financial capacity and improved access is needed to ensure that the UI safety net functions adequately in the next recession, especially for low-wage, part-time and women workers who are least likely to receive UI under current programs.

- UI benefit reserves vary dramatically among the states. Most states have prudently built reserves, providing an opportunity to reverse austerity measures imposed on the benefit side of their programs in the 1980s or to move their programs in line with a changing economy.

- Many other states have made fundamental changes in the structure of their UI financing which run counter to basic principles of social insurance, such as provisions to cut benefits despite deep recessions or uncouple indexing of benefits and wage bases.

The trend toward low reserves and less indexing of tax systems raises political and technical problems that threaten the security of this vital insurance system. The report concludes with recommendations to improve UI financing, including more progressive payroll taxes and indexing of benefits and tax bases. For many states, the first step should be reversing the trend toward cutting UI taxes while under-investing in unemployed workers.

Introduction

As this is written, the US economy has surpassed 100 consecutive months of economic expansion. Unemployment has remained below six percent since August of 1994. And though recent stock market jitters and middling output growth are cause for concern, the fact remains that the economic expansion has been lengthy, widespread, and unprecedented. In the twilight of economic expansion, the time is right for assessing the health of the nation's most important counter-cyclical income support program: the federal-state unemployment insurance (UI) system.

This brief report is motivated by five main goals:

- To provide a primer for state legislators and advocates struggling to understand the complexities of UI finance and build a stronger safety net for workers who have been left out of the unemployment system;

- To highlight the favorable timing, in many states, for expanding UI access, particularly for low-wage and women workers as state reserve funds have grown during the lengthy economic expansion;

- To encourage more thoughtful responses from states that have made potentially risky financial decisions in recent years, specifically, reducing reserves and changing tax systems in short-sighted attempts to reduce contributions;

- To shed light on the link between growing reserves and benefit restrictions since the 1980s;

- To promote fiscally responsible strategies to maintain the last remaining wage insurance program since the demise of welfare as we knew it.

It is intended as both a primer for those who are new to UI finance issues and as an enticement to action for those who have a longstanding interest in UI issues. We'll look first at some of the structural history of UI finance. Next we'll turn to the basic principles which guide the best social insurance strategies. We'll show how contradictory goals have been pursued through a range of policies — some successes, some distressing failures.

By building a foundation of understanding about UI financing strategies and outcomes, we hope to avoid some of the choices that were made in the 1990s and encourage the construction of finance and benefit systems that are both more responsive and more responsible to meet the evolving needs of today's changing workforce.

Unemployment Insurance in an Expanding Economy

One would think, given the United States' stellar economic record over recent years, that the US unemployment insurance system would be in fine shape in preparation for the next recession. After all, a fundamental premise of unemployment insurance is its "counter-cyclical" function, building UI trust fund reserves in good times and boosting economic demand in bad times. Unlike the 1982 recession which plunged almost half the states into debt to pay unemployment benefits, the 1992 recession was comparatively mild. The combination of sustained low unemployment and shallow recessions should bode well for current trust fund reserves.

This rosy scenario is made more plausible by recent history on the benefit side of the system. In theory, one might expect the percentage of the unemployed receiving benefits to be higher in good economic times. A smaller portion of the workforce is unemployed, they are more easily served by the UI system, and the percentage of the unemployed receiving benefits might climb. In fact, this view underestimates two important facts about the UI system which result in fewer of the unemployed receiving benefits and higher trust fund reserves.

First, the percentage of the unemployed receiving benefits in economic expansion tends to be lower — not higher — than during economic recessions. This happens because state eligibility criteria frequently exclude unemployed workers who are not "job losers". Workers who voluntary leave their jobs to pursue different options are "job leavers", not job losers. Job leavers are much less likely to receive unemployment benefits.[1] During economic recoveries, fewer of the unemployed are job losers, the category most likely to receive benefits, so the percentage of the unemployed receiving benefits declines. In economic downturns, more of the unemployed are job losers and the percentage of all unemployed workers receiving benefits tends to climb.

---

[1] UI is widely understood to be intended for workers who are unemployed through no fault of their own. But Bureau of Labor Statistics terms and UI definitions are poor matches. "Job losers" are involuntarily unemployed, e.g., laid off or discharged, though state UI laws may make them ineligible due to insufficient earnings or misconduct definitions. Likewise, "job leavers" may be eligible for UI in states which acknowledge the increasing role of personal factors in employment outcomes.

Figure 1
Job Losers as a Percentage of All Unemployed (1967-1999)

Source: Economic Report of the President, January 2000
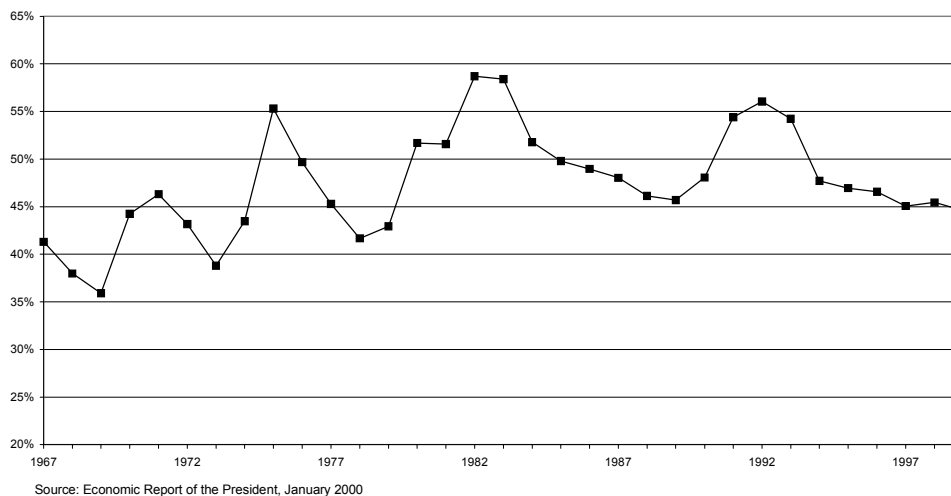
Second, recent history suggests that even job losers are less likely to receive benefits than in the past. Although beyond the scope of this discussion, numerous analyses have shown that state-level changes in the 1980s reduced access to benefits even among job losers.[2]   Key state policy factors reducing access to benefits include: expanded use of durational disqualifications which declare workers ineligible for benefits rather than delaying access to benefits, monetary eligibility thresholds which fail to account for irregular earnings, and higher requalification thresholds to return to the UI program after suffering a durational disqualification. Most measures for the percentage of the unemployed receiving benefits represent averages for all workers, but averages are misleading. The barriers to access to UI benefits do not equally affect all categories of workers. Research and experience show that women, low-wage workers, and contingent workers are less likely than other workers to be eligible for and to receive benefits.[3]

---

[2] US Department of Labor, Employment and Training Administration, "Analysis of Unemployment Insurance Recipiency Rates," UI Occasional Paper 99-7, June 1999; US General Accounting Office, "Unemployment Insurance: Program's Ability to Meet Objectives Jeopardized," GAO/HRD-93-107, September 1993.
[3] US General Accounting Office, "Unemployment Insurance: Role as a Safety Net for Low-Wage Workers is Limited," GAO-01-181, December 2000; Spalter-Roth, Yoon, and Baldwin, "Unemployment Insurance: Barriers to Access for Women and Part-time Workers," National Commission for Employment Policy, 1995.

Figure 2
Percentage of the Unemployed Collecting UI (1978-2000)
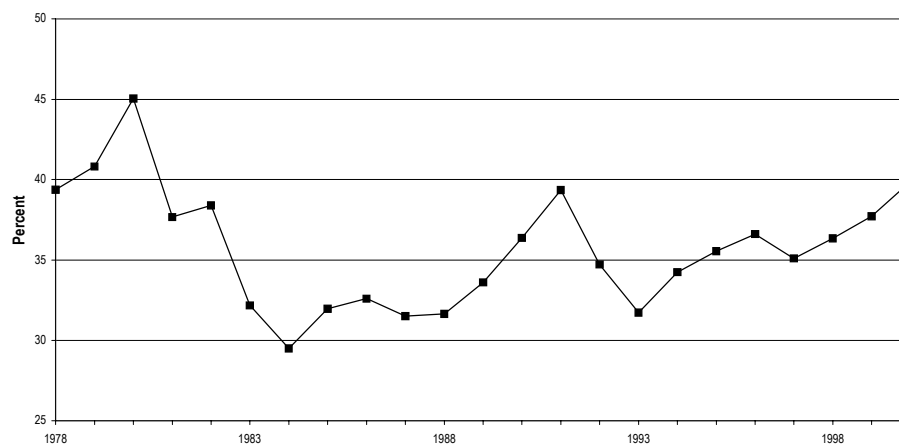
Source: U.S. Department of Labor, Office of Workforce Security

The focus of this paper is the finance side of the reform equation as a means toward improving access to benefits and re-employment. Given the unique economic context which state programs have enjoyed in recent years, what finance strategies have they pursued? Have they reaped the benefits of economic growth and laid the foundation for sustaining living standards in the next downturn? How can the financing side of the UI system be brought more in line with first principles of social insurance and tax policy?

Basic Principles: What is Unemployment Insurance Intended to Accomplish?

Unemployment insurance is often criticized as "out of date" or "a 19th century program." This criticism is leveled by both conservative and liberal critics, alike. But the fundamental goals of the system are essentially timeless.[4] They include:

■ Income support for unemployed workers. This is a microeconomic goal.

■ Counter-cyclical support for consumer demand, providing buying power in the economy to reduce unemployment. This is a macroeconomic goal.

■ Linking unemployed workers to job openings. This is a labor market efficiency goal. Workplaces have become more diverse, employment relationships more complex, and labor markets more segmented, but the underlying purpose of the system remains vitally important.

■ Increasing or retaining attachment to the labor market and specific employers. This is another labor market efficiency goal. In a modern economy, this means promoting retention of skilled employees and balancing work and family demands.

---

[4] For a compelling overview of social insurance fundamentals, see Graetz and Mashaw, True Security: Rethinking American Social Insurance, Yale University Press: 1999.

In some ways, the structure established in 1935 carried flaws which are coming to the forefront only after 65 years of experience. The goals and the structure to reach those goals are profoundly out of synch. For example, social insurance principles would suggest that minimum eligibility, benefit, and finance standards should be set nationally. A structure like this would promote uniformity of access across the country while allowing experimentation and unique local responses to unique labor market situations without endangering the underlying program.

The federal-state partnership around unemployment insurance is, in fact, the opposite structure from what social insurance would suggest. The federal payroll tax that funds state administration of the UI program is a federal prerogative, while states control virtually all the decisions which directly affect the livelihood of unemployed workers, determining benefit levels, eligibility, and duration. Delegating the core eligibility and benefit decisions to states means that these aspects of the safety net are constantly open to assault on the basis of interstate competition. This downward pressure on the claimant side of the program is a constant reminder of the compromises made in 1935 around the Social Security Act. Every other industrialized country established national standards for key program elements and a national funding system to match, precisely to avoid regional disparities.

> *"Delegating the core eligibility and benefit decisions to states means that these aspects of the safety net are constantly open to assault on the basis of interstate competition."*

Since this report focuses primarily on the tax side of the program, we won't dwell on the history of UI benefits. But the discussion of tax revenues must be informed by some understanding of the benefit side. We can only evaluate tax levels and strategies if we have some notion of what "sufficient" eligibility and benefits would entail.   It is our contention that current UI financing strategies in many states are problematic in large part because they generate too little revenue to support a UI system which meets new economic demands.

Previous research has highlighted key areas where eligibility changes are needed to improve claimant access to unemployment insurance.[5] In the absence of these improvements, many state programs are out of step with economic reality and the needs of today's changing workforce. Researchers and advocates should probe their state's eligibility and benefit side in light of the discussion of UI finance which follows. Adequate funding for an inadequate program is no virtue.

---

[5]   Vroman, "Labor Market Changes and Unemployment Insurance Benefit Availability," UI Occasional Paper 98-3, US Department of Labor, Employment and Training Administration, January 1998; National Employment Law Project, "Women, Low-Wage Workers, and the Unemployment Compensation System: State Legislative Models for Change," 1997; Maranville, "Changing Economy, Changing Lives: Unemployment Insurance and the Contingent Workforce," Boston University Public Interest Law Journal, 291, 1995.

The State Tax for State UI Benefits

This paper will focus on the largest portion of the UI financing system, the payroll tax to support state UI benefits. When most people think of UI taxes, they are thinking about this aspect of the revenue stream. But there are many parts to the revenue and benefit systems in addition to the basic state programs. On the benefit side, there are smaller federal programs to support rail employees and federal employees. The federal-state Extended Benefits (EB) program, which is half federally-funded and half state-funded, is another benefit-side program. Complicating the revenue picture is a range of smaller trust funds maintained by the federal Department of Labor to support loans to states which encounter solvency problems and funds for federal oversight. The federal partner also raises funds specifically for administration of the state UI offices and the Employment Service.[6]

Of all these various outlays and revenue sources, by far the largest is the funding stream for benefits under regular state UI programs. Taxes for state programs are determined by tax rates and tax bases. In each state, the tax rate applies to a predetermined level of payroll. This is called the taxable wage base.   In 1935, the Social Security Act — following solid social insurance principles — applied the UI administrative tax to total payrolls, but the wage base was not indexed and the taxable wage base has slipped ever since.[7]

> *"In 1935, the Social Security Act — following solid social insurance principles — applied the UI administrative tax to total payrolls, but the wage base was not indexed and the taxable wage base has slipped ever since."*

Today, no state applies UI taxes to all of covered payrolls. Some states tax only the first $7,000 of an employee's income, the current federal wage base. Other states set a higher wage base, with the average over $12,000 in 2001 (see Appendix 1). Many link their taxable wage base to some fraction of average state wages. Social insurance principles suggest that a progressive tax system would combine lower overall rates and a higher taxable base. This would mean that the tax rate would apply to more of a high wage workers' income. A taxable wage base of $7,000 might apply to 100 percent of a farm workers' wage and only a small fraction of the earnings of a skilled trades worker in manufacturing. This disparity is reduced through higher taxable wage bases.

States don't apply a fixed tax rate to all employers. Instead, the rate of payroll tax varies according to a tax schedule. This schedule of possible tax rates is linked in unique ways across each of the states to the level of trust fund reserves, the layoff history of employers, and changes in wage bases. These complex relationships are the result of a uniquely American financing approach: experience rating.

A reminder before we turn to experience rating: we are talking about improvements in a fundamentally flawed structure. Few have said this better than Graetz and Mashaw:

---

[6] Vroman, Topics in Unemployment Insurance Financing, Upjohn Institute: 1998.
[7] Blaustein, Unemployment Insurance in the United States: The First Half Century, Upjohn Institute: 1993.

There is little or nothing to be said for state financing of unemployment insurance. Because unemployment experience in different regions of the country varies, an effective insurance pool is a national insurance pool. State-level financing is the insurance equivalent of requiring that insurers insure covarying risks. And states have little capacity to take action that furthers national macroeconomic goals.[8]

So what follows is a discussion of failures and improvements of state financing — modifications that may be necessary, but far short of the comprehensive, national solution which true social insurance would suggest.

Basic State Finance Structures: Experience Rating

The United States is the only industrialized country with an "experience rated" unemployment tax system. Experience rating takes many forms, which we'll discuss below, but the basic idea is to link tax rates to the layoff history of individual employers. The *degree* of experience rating is determined by how directly or indirectly a specific employer's tax rate is linked to benefits paid to their workers.

Experience Rating and the History of the New Deal

Although experience rating has become a pervasive part of the unemployment insurance system, it was by no means a foregone conclusion that experience rating would be part of the original Social Security Act. Two competing models were being advanced at the time of the Social Security Act deliberations. The "Wisconsin Plan" included experience ratings, advocated as a way to reduce layoffs by raising the cost of additional layoffs by employers. The "Ohio Plan" didn't include experience rating. This model was based on the premise that all employers benefit from the counter-cyclical function of unemployment insurance, whether directly from unemployed workers spending benefit checks or indirectly through higher economic growth. The Ohio plan initially won the debate and experience rating was not part of the House bill.[9]   Employer interests prevailed in the Senate version, promoting experience rating as a way to encourage employer participation in the system and to allocate tax burdens on the basis of an employer's layoff history.

The decision to connect tax rates to individual employer behavior has had three broad, pervasive effects. First, it has encouraged employers to view UI trust funds as "their" money. In fact, like all payroll taxes, the money for the tax can come from profits, wages, or

---

[8] <u>True Security: Rethinking American Social Insurance</u>, p. 199, <u>supra</u> at footnote 4. My affection for their views on state financing does not apply to their idea for a so-called 50/50 payroll tax, benefits that vary by duration, and other proposals they advance.

[9]   Haber and Murray, <u>Unemployment Insurance in the American Economy</u>, Richard D. Irwin: 1966.

prices paid by consumers. In research funded by the Chambers of Commerce in Kentucky, authors from the Center for Business and Economic Research and the University of Louisville found, "While statutorily UI may be collected from the employer, it could well be, and research suggests it is the case, that high UI taxes in a state merely result in lower wages paid to employees. Thus, while statutorily the incidence of the tax is on the employer, it is probably in fact borne by employees in the form of lower wages."[10] Experience rating confuses the reality that employers collect the UI tax, but workers ultimately pay it. Of course, this doesn't mean that reductions in UI taxes automatically become wage increases, though they could be used for that purpose. Second, experience rating means that employers can reduce their taxes by disputing UI claims. This has generated an entire industry of consultants who help employers keep claimants from receiving benefits. Third, experience rating generates a belief that claimants should only receive benefits if the employer is at fault. This notion flows logically from an experience rated tax system, but is cold comfort to workers who find themselves unemployed for the "wrong" reasons.

The idea behind experience rating is simple enough, charging benefit costs more directly to employers who cause the layoffs by raising the rate of payroll tax as more of their workers successfully apply for benefits. The implementation is more complex. Remember the second goal of the program, increasing demand during economic downturns. True experience rating runs directly counter to this goal. If employers contribute immediately to restore drained unemployment reserves, they will be paying higher UI taxes precisely when they may be less able to afford the outlay. Raising taxes during an economic recession may exacerbate the downturn, causing more layoffs rather than fewer. This is why healthy trust fund reserves are so important. To meet the counter-cyclical goal of the program, the tax system should raise reserves during strong economic times and spend them down during recessions.

In practice, states have tried to balance the contradictory goals of experience rating and counter-cyclical financing in three ways. First, they build UI trust fund reserves so that funds can be drawn down without immediately prompting higher taxes. Second, they have not fully experience rated their systems.   That is, they have not raised revenues exactly one-for-one from employers whose workers receive unemployment benefits. Using the Department of Labor "experience rating index," Vroman found that the national average hovered around 60 to 70 percent of full experience rating.[11] And third, they have built lags into their programs so taxes are not raised immediately (pro-cyclically), but instead are raised at some point after the layoffs occur.

The extent to which fund reserves are used to cushion tax changes has declined over time. As the graph shows, in 1948, nationwide trust fund reserves represented about eight percent of total payrolls. By 1979, reserves had decline to less than one percent of total payrolls.

---

[10] Hoyt, Berger, and Coomes, "Statutory and Economic Incidence of Taxes in Kentucky and Surrounding States," Center for Business and Economic Research, January 24, 2001.

[11]   Vroman, "Tax Equity Study Final Report: Unemployment Insurance Tax Equity in Washington," Report Number 3, January 1999.

Figure 3
Trust Funds as a Percentage of Total Wages (1950-2000)

Source: U.S. Department of Labor, Office of Workforce Security
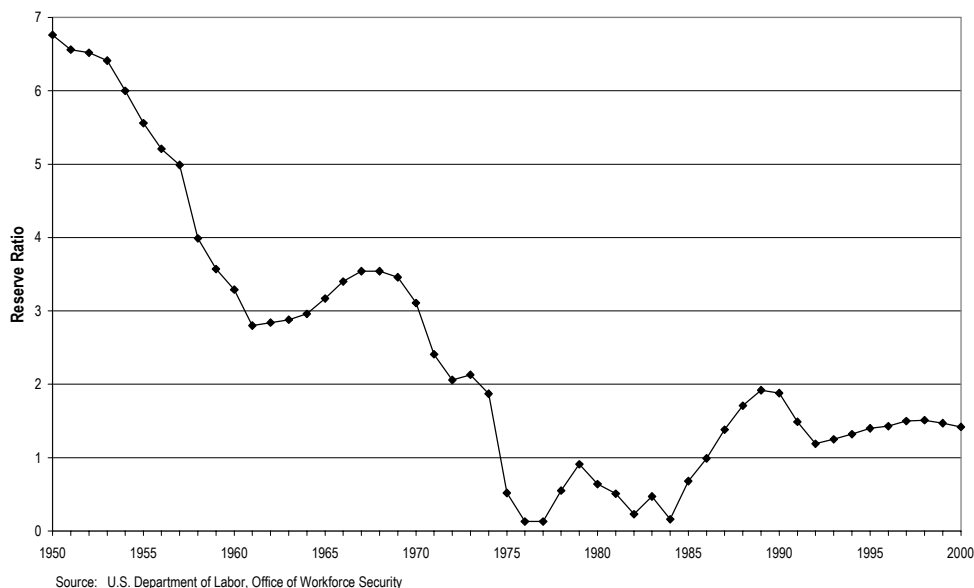
The large buffers which characterized the system in its early years are no longer maintained by any state. Instead, states have changed their financial strategies to combine smaller reserves and more rapid repayment of trust funds as they are drawn down.[12] This shift in strategy reflects pressure to reduce the amount of revenue which is withdrawn from the economy to wait in reserves, improved accuracy of financial forecasting, and more complex methods of experience rating state systems.

To promote more flexible financing and lower reserves, experience rating has been incorporated into detailed tax arrays. These systems combine a list of tax rates which are in effect at a given trust fund level and experience rating to determine an individual employers' tax rate within the relevant schedule. The COLUMNS of a tax schedule show which set of tax rates is in effect. The overall state of the UI trust fund determines which COLUMN in the tax schedule is in effect. At any given time, all covered employers will be subject to the tax schedule in one column of the array. Tax rates are found by looking at the ROWS of a tax schedule. The individual employer's tax rate is then determined relative to other employers, as shown in the rows of the column. An example of a tax array is shown in Appendix 2. Not all states use tax arrays, which can lead to a different set of problems in those states.

The relationship between the rows and columns of a tax array is extremely important. There is more than one tax schedule in a given state because the highest tax bracket may not be enough to replenish the trust fund in a deep recession. Instead, the overall health of the fund may trigger a move to a higher tax schedule. It may also trigger surcharges on some employers or a combination of a schedule change and a surcharge, depending on the state. Differences in state tax systems include the way they determine where employers will

---

[12] Miller, Pavosevich, and Vroman, "Trends in Unemployment Benefits Financing," in O'Leary and Wander, eds, Unemployment Insurance in the United States: Analysis of Policy Issues, W.E. Upjohn Institute: 1997.

fall within a given tax schedule and how tax rates will change as the schedule shifts in response to higher or lower trust fund reserves.


State Strategies for Tax Schedules

There are four basic experience rating structures in use: reserve ratios (33 states), benefit ratios (17 states), benefit-wage ratios (2 states) and payroll decline (Alaska). These labels describe the ratio that is used to determine an individual company's tax rate within a tax schedule. In reserve ratio states, benefits paid to an employer's workers are compared to taxes paid by that employer. The reserves in an employer's account are then divided by average payrolls. In most cases these calculations use all prior benefits, all prior taxes, and three years of payroll to make the calculations. The ratio of reserves to payrolls determines an employer's position in the tax schedule. In benefit ratio states, tax rates are determined by comparing benefits paid over a base period to payrolls over the same period. Benefit-wage ratio calculations looks at benefits paid to individual workers compared to wages paid to those same workers.   The payroll decline system compares payroll levels over time. These various ratios are used for the same purpose: to assign tax rates within a tax schedule that is determined by the overall trust fund balance.

Another key difference across experience rating systems is found on the benefit side. Not all allowable claims are experience rated. Experience rating is designed to link employer taxes to employer layoff history. But some categories of benefit payments have been allowed to fall outside the experience rating relationship. These benefits are called "non-charged," capturing the fact that payment of benefits to these claimants are not charged directly to their employers through the higher experience rated taxes. Every state allows some benefit payments to be non-charged. Non-charging of benefits paid under voluntary quits or misconduct discharges are the most common allowances.

Taken together, the tremendous scope for differences across state tax systems — variation in minimum and maximum tax rates, differences in methods of calculating changes in tax schedules, taxable wage bases and indexing, non-charging of benefits, special surcharges under unique circumstances — produces a terribly confusing patchwork of systems. It also means that responsiveness to changing economic circumstances varies widely around the country.

Beneath all the complexity, the ultimate goals are the same. The UI tax system should produce adequate revenue to fund a well-designed benefit system and it should produce that revenue without making economic downturns worse by taxing employers most heavily during recessions. Taxes should go up in good times and down in bad. The most sophisticated tax system is useless if it raises unemployment through poor timing of tax increases. Figure 4 shows how well state systems have met this crucial test in recent history.

Figure 4
Unemployment Rate and UI Tax on Total Wages (1950-2000)

Source: U.S. Department of Labor, Office of Workforce Security
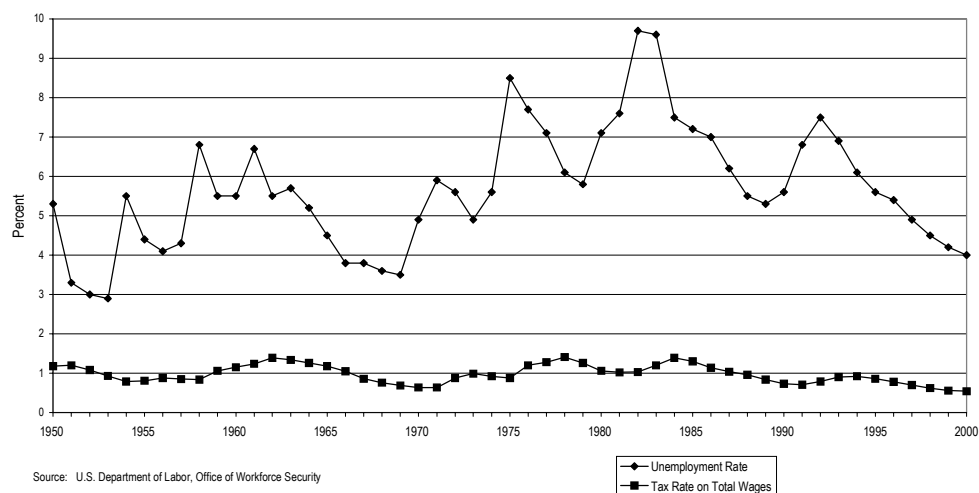
At the most basic level, the admonition to "first do no harm" seems to be met. Tax rates are not peaking when unemployment is highest. Tax rates fall as unemployment rates rise. For all the complexity discussed above, the basic relationship between unemployment cycles and the timing of taxes seems to be working. Yet, even at this level, it is clear that something has changed in recent years. The timing of the relationships seems intact, but the scale of responses has changed notably. To find out how, we have to look at federal and state responses to the deep Reagan recession of 1982.

The Legacy of the 1980s

Because trust funds and taxes are constantly changing, a single snapshot of state trust funds is not helpful. You have to look at how they change over time. Recent finance history is perhaps best understood by starting in 1982. 1982 was a terrible year. The US lost 1.4 million manufacturing jobs, the Grammy Award for Best Album went to "Toto IV," and the unemployment rate hit a post-War high of 9.7 percent. But perhaps most important, almost half the states in the country (22) had to borrow federal funds to pay unemployed workers. They hadn't foreseen the depth and strength of that recession. American manufacturing, in particular, took a beating and manufacturing workers are both more likely than other workers to receive benefits and more likely to receive larger benefit checks because their previous earnings tend to be higher than average claimants.

This intense depletion of funds set off a period of dramatic restructuring. The reshaping of UI finance included several changes. First, the federal partner, through Congress, made several changes in the Omnibus Budget Reconciliation Act (OBRA) of 1981 which altered the terms of discussion in states during the recession. In an effort to discourage future borrowing, OBRA required the Department of Labor to charge states interest on loans which were required for providing benefits. Raising the cost of borrowing was intended to promote larger reserves, but the change occurred before states could prepare for the recession.

Second, Congress took more direct steps to impose austerity in state UI programs, using the leverage of the federal-state Extended Benefits program which paid benefits to the longer term unemployed during periods of uncharacteristically high unemployment. Congress eliminated the national Extended Benefits (EB) trigger in 1981 and changed the state triggers which allow benefits under the federal-state EB program. Later, Congress essentially voided state suitable work requirements under EB, mandated that state benefit amounts be rounded down to the nearest dollar, added durational disqualifications to the EB program, and required states to pay the entire cost of the first week of EB if they didn't impose a waiting week. Taken together, the federal partner effectively gutted the EB program, a policy shift which proved extremely costly when a less targeted Emergency Unemployment Compensation program was enacted during the 1992 recession.[13]

Third, in response to the deep hole of the 1982 recession and to avoid imposing higher tax burdens on all employers, virtually all states created new surcharges outside their experience rating systems. Many of these surcharges were imposed on "negative balance" employers, that is, employers whose taxes under experience rating were well below the level needed to replenish their share of UI trust funds.

It's noteworthy, and commendable, that some states used surcharges to provide administrative funds — historically the role of the tax levied by the federal partner. These funds were needed as a result of the insufficient funding formula used by the Department of Labor and Congress to fund the national Employment Service, a sorry history which is beyond the scope of this paper, but which spawned a vast revolt against the federal administrative financing structure from the late 1990s into today.[14]

Fourth, state agencies and legislatures began to get nervous about the underlying linkages within their UI programs. As an insurance program, it is vital that the UI system link benefits to the economic outcome which is being insured, namely previous wages. As a revenue strategy, it is important to link the tax system over time to the same moving target. As wages rise, the taxable wage base should rise. In practice, many more states index their benefits to state average wages than index their taxable wage bases to state wages. In 1982, 27 states used the federal minimum taxable wage base ($6,000 at the time) as their state wage base. As this is

> *"As a revenue strategy, it is important to link the tax system over time to the same moving target. As wages rise, the taxable wage base should rise. In practice, many more states index their benefits to state average wages than index their taxable wage bases to state wages."*

written, 11 states used the federal taxable wage base as their state taxable wage base. The combination of indexed benefits and tax systems based on legislated wage bases was unsustainable for many states in the aftermath of the 1982 recession. Almost all states

---

[13] Corson, Needels, and Nicholson, "Emergency Unemployment Compensation: The 1990s Experience," US Department of Labor, Employment and Training Administration, Revised January 1999.
[14] In the late 1990s, a coalition formed to encourage "devolution" of UI administrative funding. Eventually, they set aside their unworkable plan and joined an effort to build a consensus approach. As this is written, the need for a balanced combination of tax breaks, benefit improvements, and a workable administrative funding formula is greater than ever, but distressingly unlikely.

raised their taxable wage bases as a result of the 1982 recession, but, as we'll see, only 16 states index their wage bases to some fraction of state average wages.

Of special concern, states also restricted UI eligibility in hopes of promoting solvent trust funds in the future. At the broadest level, state UI outlays are related to three factors: how many people are eligible for benefits (the percentage of the unemployed receiving), how much each claimant receives (the wage replacement rate), and how long each claimant receives

> *"Ironically, reducing access to benefits also reduces revenue (because of experience rating), so the relative gains to trust funds are minimized."*

benefits (maximum duration of benefits). At least one of these components of benefit outlays was constrained in each state after 1982. Some states which had provided a maximum duration of 30 weeks reduced their maximum durations to 26 weeks. Some states capped their maximum benefits or changed their benefit calculation based on prior earnings. The overwhelming system wide response, however, was to restrict entry, reducing the percentage of the unemployed receiving benefits. Ironically, reducing access to benefits also reduces revenue (because of experience rating), so the relative gains to trust funds are minimized.

Sometimes benefit restrictions and revenue expansions were combined. In a hint of things to come, the 1980s surcharges were often adopted along with benefit cuts under the guise of equal sharing of the burden of trust fund solvency -- only to lift that burden unequally in later years.

Examples of State Funding & Benefit Deals

From 1980 to 1982, **Michigan** adopted solvency legislation that raised the state's taxable wage base to $9,500 in steps, increased payroll taxes, and imposed surcharges on negative balance employers. On the benefit side, monetary eligibility was raised from 14 weeks of work to 20 weeks of work, maximum benefits were frozen for 5 years, and tougher disqualification penalties were adopted. Maximum benefits were later raised from their 1986 levels, but none of the other benefit restrictions were reversed. In 1996, the legislature again froze maximum UI benefits and adopted other eligibility restrictions while adopting a UI tax cut that reduced UI revenues by over $800 million. A 1997 increase in the state minimum wage from $3.35 an hour to $5.15 an hour raised the monetary eligibility threshold (which, unlike benefits, remained indexed) to 30 times the new minimum wage, or $154.40 instead of $100.50 a week.

Illinois, in 1981, adopted an increase in monetary eligibility requirements, substituted durational disqualifications for denial periods, and restricted "good cause" for leaving work to work related reasons. Later, in a 1983 "UI Summit", a permanent change in weekly UI benefit amounts and maximum weekly benefit calculations (using 48 percent of state average wages instead of 50 percent) was passed. Only the benefit level change was partially restored (49.5 percent) and has since been frozen. The other benefit and eligibility changes remain today, despite a 1996 payroll tax deduction that has saved employers about $130 million.

As we'll see, the expansion of the 1990s was seen in many states as an opportunity to reduce UI taxes, but not to reverse the 1980s restrictions on benefit levels, benefit durations, and eligibility.[15]

How Much is Enough?: Recent History and Measures of Solvency

Much as the 1982 recession squeezed inflation out of the US economy, so the aftermath of the 1982 recession called into question many of the relationships existing within state UI finance systems. Eligibility restrictions ensued, benefit levels were reduced, durations constrained, financial systems transformed through surcharges and new tax arrays, new forms of indexing were implemented, and new technologies adopted to increase program efficiency. This overall belt-tightening (while detrimental to claimants and employers) should have resulted in widespread improvements in trust fund reserves all over the country during the upswing in the business cycle. The fact that the 1992 recession was relatively mild was a lucky break. The fact that the 1992 to 2000 economic expansion has proven so long lived is practically miraculous.

It's safe to say that no state unemployment agency would have anticipated the economic boom of the 1990s. Most mainstream economists, if they are honest, would have to admit that the current low unemployment rate and minimal inflation were essentially impossible given their theoretical perspective.[16]   As this is written, the economy shows signs of slowing, but not after posting the longest economic expansion (over 110 months) measured by the National Bureau of Economic Research. Unemployment has been below six percent since 1994. At the same time, wages have only recently returned to 1979 levels, on average, after adjusting for inflation. Benefit restrictions, historically long economic recovery, and historically low unemployment rates have reduced the number of claimants in the UI system and low wage gains have reduced potential benefits to those few claimants.

So trust fund reserves should be skyrocketing. And they were, or are, sort of. The story's a bit complicated. Mostly there's good news, making it possible in most states to fund UI reforms needed to address the needs of today's workers. But we have to ask the right question and look at the range of experiences across states.

Trust Fund Reserves

If you look at dollars in the state trust funds, you'd say the funds have expanded enormously. In 1982, almost half the state funds were empty. Technically, they were more

---

[15] "Unemployment Insurance: Role as a Safety Net for Low-Wage Workers is Limited," supra at footnote 3; Emsellem, "State UI Legislative Highlights, 1996-2000: Expanding Unemployment Insurance for Low-Wage, Women and Contingent Workers," National Employment Law Project, Revised July 2000.

[16] The so-called "NAIRU" has been thought to be the floor for non-inflationary unemployment rates. Despite being a natural law, the NAIRU was moved downward, apparently, by the 1990s economy.

than empty; they were negative. In 1992, the state funds held $32.2 billion in 1999 dollars. In 1999, they held $50.3 billion. The economic recovery helped put over $18 billion into state reserves, a real increase of 56 percent. This increase has not happened uniformly over time, though, and it is certainly not evenly distributed among the states.

Figure 5 shows the inflation-adjusted change in trust fund reserves, nationwide, each year of the economic expansion. Recall that under experience rating, two things should be true. Taxes should rise after recessions not during recessions, so tax revenues rise in good times not in bad times. And tax revenues should decline at least somewhat after trust fund reserves are restored. Since we can see many years of the long recovery of the 1990s, we should find evidence of both effects: rising revenues early and declining revenues later in the recovery. Figure 5 suggests exactly that. Maybe.

Figure 5
Inflation Adjusted Change in Trust Fund Balances (1992-2000)

Source: Department of Labor, Bureau of Labor Statistics.
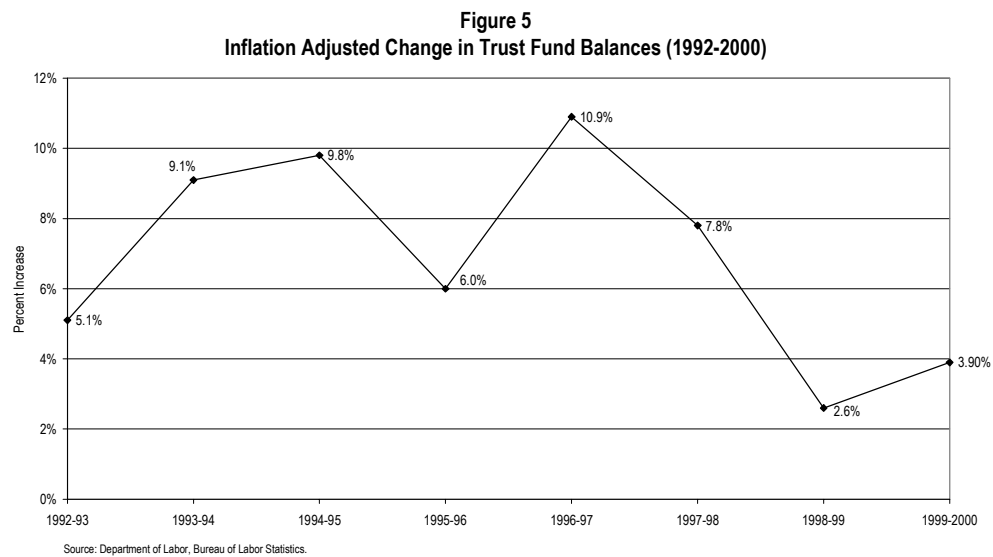
Looking at dollar reserves in state accounts is potentially misleading. Trust fund reserves are relative. The important question is not whether there are large reserves, but whether current reserves are large enough relative to potential demands on the system. Funds are only "large" relative to the needs of future unemployed workers. That's what makes the funds insurance.

There are three important measures for evaluating trust funds relative to potential demand. Each is relevant, depending on the question being asked. The three measures are:

- Trust funds compared to recent benefit history in each state.

- Trust funds compared to long term benefit history in each state.

- Trust funds as a percentage of total payrolls.

Appendix 3 shows each of these measures, described below, for each of the states for 2000, the most recent full year available.

Average High Cost Multiple

Since trust fund reserves don't tell the whole story, it's necessary to evaluate how states are doing based on recognized standards of solvency. The measure most commonly used is called the average high cost multiple (AHCM). Multiplying the AHCM by 12 tells, roughly, how many months of benefits could be paid if a state experienced a recession like its most recent deep recession. Although the ratio involved may be difficult to explain, the outcome measure of months of benefits answers the common sense question of how long a trust fund might last. A state with an ACHM of 1.0 can pay benefits for one year at predictable recession levels without taking in any additional revenue. The AHCM only considers more recent recession experience, namely the last 20 years. The shorter time horizon reflects the belief that more recent experience is a better predictor of future experience.

The AHCM has an important history within the UI world. The Advisory Council on Unemployment Compensation (ACUC) in 1995 recommended that an AHCM of 1.0 be adopted as a threshold for solvency.[17] They wrote:

> Congress should establish an explicit goal to promote the forward funding of the Unemployment Insurance system. In particular, during periods of economic health, each state should be encouraged to accumulate reserves sufficient to pay at least one year of Unemployment Insurance benefits at levels comparable to its previous "high cost." For purposes of establishing this forward-funding goal, previous "high cost" should be defined as the average of the three highest annual levels of Unemployment Insurance benefits that a state has paid in any of the previous 20 calendar years.[18]

When state legislators or advocates want to evaluate existing reserves relative to potential demands, the ACUC recommendation may be as close to a Blue Ribbon endorsement of the AHCM as you can get.

Because the AHCM is such an important measure, it's useful to examine this ratio in some specific settings. The graph shows the changing AHCM from 1979 to most recent data.

---

[17] It is important to note that this ACUC recommendation was directed at Congressional action. The Advisory Council rarely made federal recommendations, preferring instead to admonish the states to take action. The fact that the solvency standard is a rare ACUC recommendation for a federal standard makes it even more significant.

[18] Advisory Council on Unemployment Compensation, "Collected Findings and Recommendations: 1994-1996," at p. 11.

Figure 6
Average High Cost Multiple (1979-2000)
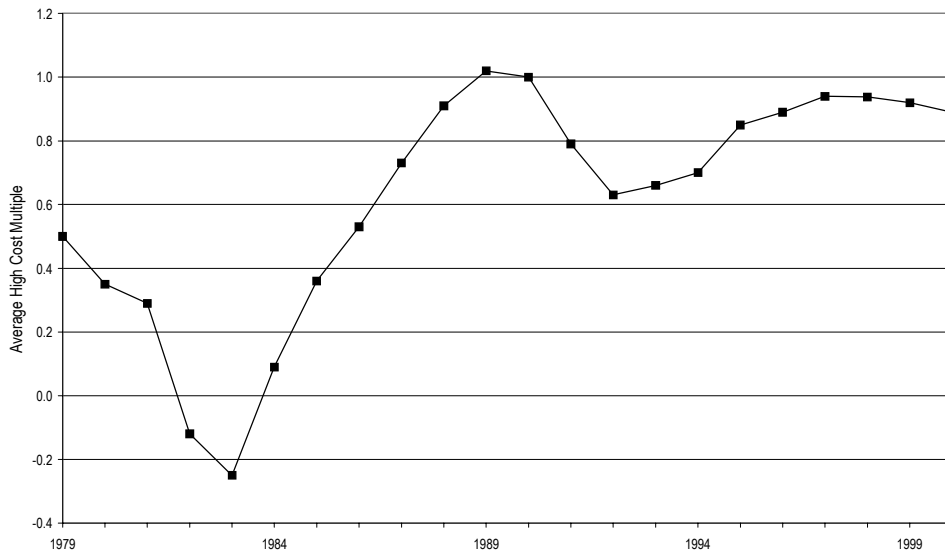
Source: U.S. Department of Labor, Office of Workforce Security

The good news is the improvement in the AHCM since the 1992 recovery, up from 8 months of recession-level benefits to almost a year. The bad news is the 2000 level is still below the recognized solvency threshold despite building reserves throughout the longest economic recovery since World War II.

> *"A more principled approach would be to design an adequate, accessible benefit program and link it to a suitable revenue strategy."*

Most states have, in fact, taken advantage of unprecedented economic expansion to build reserves for the next downturn. Most states (30) have trust fund reserves at or above recognized solvency thresholds. Some (Delaware, New Hampshire, New Mexico, Vermont) have reserves at or above twice the recognized standard, meaning they have around two years of recession-level benefits in reserve. Yet several states have essentially squandered the opportunity which sustained economic growth has provided to prepare for an economic downturn. Five states (Illinois, New York, North Dakota, Texas, and West Virginia) had AHCMs of half or less of the recommended solvency threshold. The obvious problem now for these states is that poor choices about adequate funding in the past are often used to justify austerity in benefits now. It is at best dishonest for these states to ignore solvency thresholds in the effort to cut taxes, but now resort to solvency concerns in an effort to avoid benefit reform. A more principled approach would be to design an adequate, accessible benefit program and link it to a suitable revenue strategy.

High Cost Multiple

The High Cost Multiple (HCM) looks further back in time to compare reserves to benefit outlays. It is the second highest threshold for evaluating trust fund solvency. Unlike the

reserve ratio, which compares trust funds to all payrolls regardless of existing program conditions, the High Cost Multiple compares trust fund reserves to each state's experience with benefit outlays. Specifically, it compares two ratios. The numerator (top of the fraction) is the ratio of benefits paid during the 12 month period with highest outlays since 1958 to total payrolls during that 12 months. The denominator (bottom of the fraction) is the reserve ratio discussed above. Taken together, the resulting ratio tells how large current reserves are relative to outlays in the year with highest benefit outlays in a state. The measure is useful because it incorporates both a state's own eligibility and benefit history and a state's own experience with economic recessions. It is potentially misleading, however, because state programs change over time and economic recessions in the future may be very different from those in the distant past (assuming the deepest state-level recession is, in fact, distant).

In 2000, the national HCM was .64 translating into about 8 months of benefits at 1975 recession levels. The highest state reserves by this measure were in New Mexico (2.4). Twelve states had HCM's equal to or greater than 1.0. This is a reassuring number, to some extent, given the widespread belief that future recessions will not, in fact, require reserves sufficient to meet the challenge of the most demanding recession in a state's history. At the end of 2000, 12 states were at least nominally prepared for such an event. On the glass-half-empty side, the five states with the highest total weeks compensated in 2000 (California, Illinois, New York, Pennsylvania, Texas) had a combined simple average HCM of just .38, four and a half months of deep-recession level benefits.[19] Again, this long-term starvation of the revenue side of the program is no justification for inadequate eligibility and benefit strategies. Social insurance worthy of the name demands attention to both wage replacement and revenue adequacy.

Trust Funds Compared to Payrolls

This measure is dollars in each state trust fund divided by the dollar value of all payrolls covered by unemployment insurance in the state. It is expressed as a percentage. It is the highest possible threshold of solvency. In effect, it evaluates trust fund reserves relative to complete wage insurance. It answers the question: how does the state trust fund compare with the maximum possible demands from a wage insurance system? At the end of 2000, the US average was 1.5 percent, meaning state trust funds could replace one-and-a-half percent of all wages. Reserve ratios varied from 4.1 percent in Vermont to less than one percent in Alabama, Minnesota, Missouri, Nebraska, New York, North and South Dakota and Texas. In 1982, when so many states were insolvent, the national reserve ratio was 0.00 percent.

Summary

Looking at four measures — trust fund levels, reserve ratios, high cost multiples and average high cost multiples — is there a coherent picture of UI finance in the year 2000? A few insights:

---

[19] In a telephone conversation, Wayne Vroman notes that this finding is true throughout the 1990s and across all the states which account for more than half of all covered employment.

■ Nationwide, the trust funds have grown substantially since the 1992 recession. This is almost unavoidable given the remarkable economic expansion, sustained low unemployment, and UI eligibility restrictions of the past 20 years.

■ By the most widely recognized measure of solvency (the AHCM), the average of all state trust funds is still slightly below recommended reserve levels. This average masks important differences among the states. The majority of states have built reserves during the recovery and have reserves at or above recognized desirable thresholds, facilitating the kinds of UI reforms being advanced in many states. A few states have built the scale of reserves which one might expect given US economic performance. Yet a sizeable number of states remain well below recognized solvency standards. The decisions these states have made — particularly given the number of workers employed in these states — will redound to the entire economy when the next recession arrives.

■ By the gloomiest measure, the High Cost Multiple, states are poorly prepared for paying benefits at the rate they did in more distant recessions. Maybe they don't need to worry about a recession like 1975. Maybe they wouldn't pay 1975 level benefits even at 1975 level unemployment. But it bears consideration: what if the next recession is more like distant, deep recessions than more recent, shallow recessions?

Sustained economic expansion has had the expected positive effect on most state trust funds. They have recovered fully from the 1992 recession and most -- with some large exceptions -- appear up to the task of meeting the next recession, particularly if that recession is delayed in arrival. Having said that, it is troubling to see how few states are prepared for sustained deep recessions or, in the case of a handful of states, even a shallow economic downturn. These states pose the question: how on earth can so many states be so far from overwhelmingly flush given the best economic performance in over 50 years?

The 1990s and the Rush to Cut Taxes

A look at recent events raises concern about whether the traditional relationship between experience rating and the economy will hold in the future. In good economic times, trust funds are built and taxes, once funds are solvent, may fall. These relationships are largely automatic, functioning through state programs on the basis of calculations linking tax rates to trust fund reserves over time. But these automatic relationships have been circumvented or accelerated in many states in recent years. Replacing trust fund calculations with short-term political considerations may prove difficult to reverse in the face of an economic downturn.

The trend toward lower UI taxes is both a long term trend and a recent phenomenon. The long term trend is undeniable. Figure 7 shows UI tax rates as percentage of total payrolls since 1950.

Figure 7
UI Taxes as a Percentage of Total Wages (1950-2000)

Source: U.S. Department of Labor, Office of Workforce Security
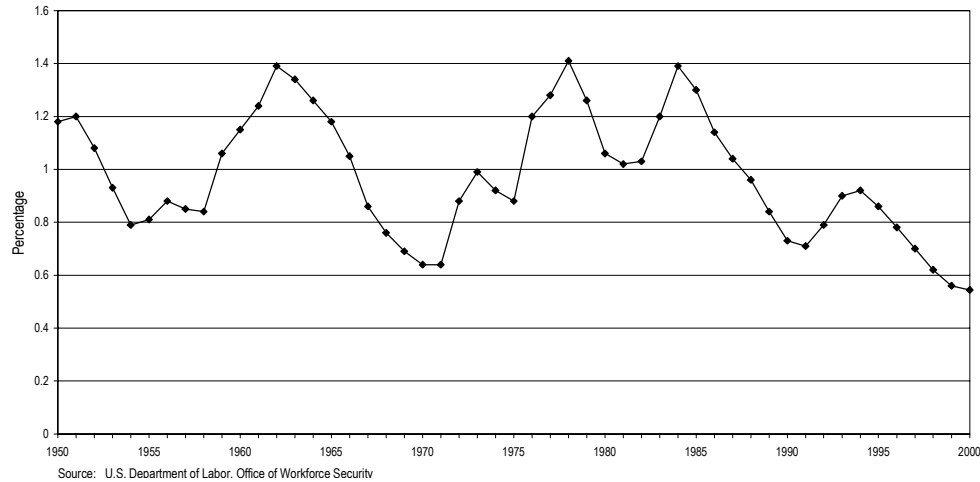
This is an important measure for UI tax rates because it captures both the tax rate and the taxable wage base. Another commonly used measure — tax rates on taxable payrolls — will not show the effect of differing taxable wage bases across states. In 1950, UI taxes were 1.18 percent of total payrolls. By 2000, due to the combination of declining taxable wage bases and declining tax rates, UI taxes were .54 percent of total payrolls.

Because experience rating makes taxes vary with the business cycle, it is helpful to compare similar portions of business cycles over time. Figure 8 compares average taxes on total covered payrolls in each of the post-War economic upswings. Expansions of less than three years are excluded because of the lags built into many experience rating systems.

Figure 8
Comparing Post-War Expansions: Average Tax on Total Wages
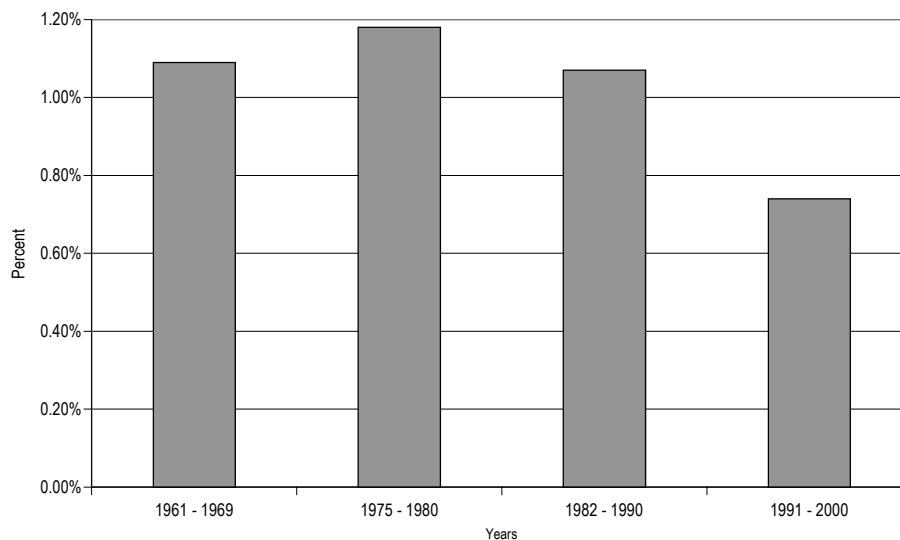
Sources: National Bureau of Economic Research, "US Business Cycle Expansions and Contractions"; Tax data from US Department of Labor, UI Service, Actuarial Services Division.

Two facts are apparent. First, until the 1990s, tax rates changed in fairly similar ways during successive economic expansions. Taxes as a percent of total covered payrolls averaged just over one percent during each upswing in the business cycle. This changed in the 1990s, both at the national and state levels (Appendix 4). Second, tax rates averaged across the years of the 1990s expansion were notably lower than any of the preceding recoveries. Taxes were at least one-fourth lower than any of the preceding expansionary periods.

The long term picture shows that UI taxes rise and fall with economic conditions as experience rating would suggest. But the cyclical rise and fall of tax rates is less dramatic than the long term decline in taxes. UI taxes as a percentage of total payrolls were lower in 2000 than any time in the history of the US unemployment insurance system.

> *"UI taxes as a percentage of total payrolls were lower in 2000 than any time in the history of the US unemployment insurance system."*

The change in financial behavior during the 1990s can be highlighted in another way, by looking at change over time during a similar economic period. In many ways, the 1961-1969 economic expansion was comparable to the 1989-1999 expansion. The previous recovery was the longest to that point. Both are over 100 months, though the end is not yet in sight for the current expansion. Unemployment rates were similar. The 1990s recovery has lasted longer and pushed unemployment lower, but the periods are roughly comparable. What is not comparable is the impact on UI trust funds.

Figure 9 shows UI tax rates and UI trust funds during the two economic expansions.

Figure 9
UI Trust Funds and Taxes: Contrasting Responses in Two Expansions
(1959-1969 and 1989-1999)

Source: US Department of Labor, "ET Handbook No. 394". 1999 data from US
Department of Labor, "UI Data Summary."
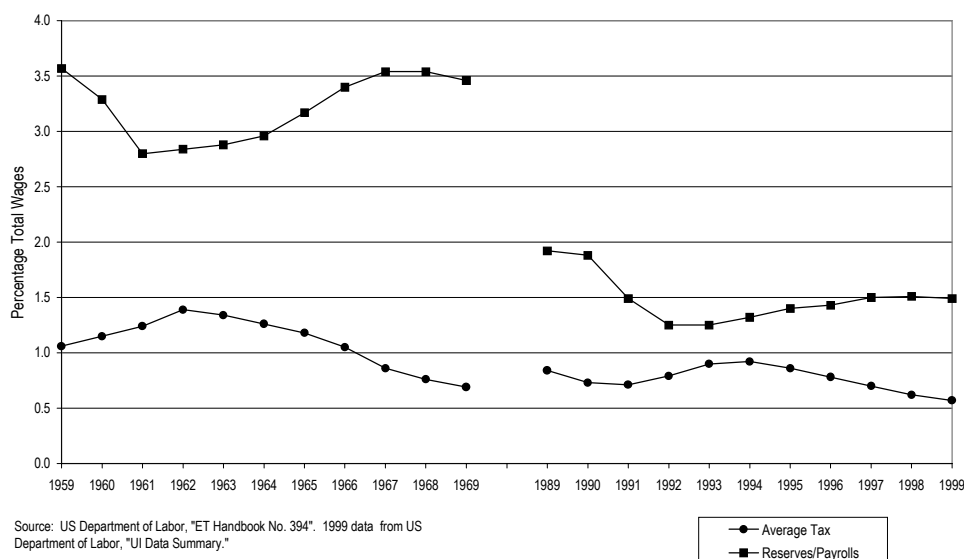
The figure shows that, compared to a previous lengthy economic expansion, the 1990s expansion involved lower UI taxes and resulted in a smaller increase in UI reserves.

This decline in tax rates was due to two factors. First, as discussed above, it is the nature of experience rating to see taxes decline automatically as trust fund reserves are built. This occurs as tax schedules shift downward in response to higher reserve ratios. The comparison between the 1960s recovery and 1990s recovery shows that taxes and reserves responded as expected under experience rating, but taxes in the 1990s recovery did not return to the level of the 1960s, suggesting the need for further explanation.

A second reason for declining taxes is concerted tax cut activity during the 1990s. Although the focus here is unemployment insurance, the rush to cut UI taxes is part of a much larger trend in the 1990s toward business tax cuts.[20] In a short time in the 1990s, several states cut UI taxes by billions of dollars.[21]

■   In 1998, Georgia enacted a $122 million tax cut for two years. The next year, the state enacted legislation cutting another $1 billion over four years. Even with reduced taxes, the Georgia trust fund is generating $100 million a year in interest, yet the legislature has refused to pass a $19 million UI expansion, including an alternate base period.

■   Also in 1998, Idaho cut UI taxes by $31 million along with a projected $112 million over four years, a 30 percent reduction in UI taxes.

---

[20] See, for example, Institute on Taxation and Economic Policy, "Corporate Income Taxes in the 1990s," October 2000.
[21] Statement of Maurice Emsellem of the National Employment Law Project, Subcommittee on Human Resources, Committee on Ways & Means, US House of Representatives, March 9, 2000.

- In 1995, Maryland cut taxes by $410 million over five years.

- In 1999, the Governor of Massachusetts proposed $203 million in UI tax cuts. The legislature instead froze taxes to avoid an increase, costing the trust fund $120 million.

- Michigan, in 1996, cut taxes 10 percent, taking approximately $500 million out of the trust fund over three years. The legislation included automatic additional cuts if trust fund reserves rose. Since 1996, the automatic provisions have taken $750 million out of the fund.

- New Jersey, also in 1996, cut taxes and took $200 million a year out of the forecast fund balance. More cuts followed in 1997, making a total annual cut of $450 million.

- In 1998, New York cut taxes by $420 million, dropping UI taxes 27 percent.

- South Carolina cut taxes in half in 1998, taking about $50 million out of the trust fund.

- In 1999, Washington froze its taxable wage base, moved to three-year averaging of state wages for calculating the wage base in the future, stopped an automatic move to a higher tax schedule, and provided additional tax cuts for employers in the middle of the tax schedule. These cuts were expected to remove $590 million from the trust fund over six years. This estimate has proven low given the current forecast for the next shift in the tax schedule.

Given resulting low reserves, some of these tax cut efforts seem irresponsible at best. In a few cases, tax cuts were justified by large trust fund reserves, reserves which were genuine surpluses in the sense that they were well above the solvency thresholds discussed earlier. The Washington state tax cuts, for example, were pursued in a flush system with a reasonable level of program access for workers. The tax cuts were combined with creation of a unique income support program for displaced workers in training. The tax cuts also left room in the trust fund for further expansion of access to benefits in the future. In Washington state, the specific mix of tax cuts, income support for training, and changes in eligibility has proven controversial, but the approach of combining tax cuts and benefit enhancements in response to sizeable fund reserves has not.

This balanced approach contrasts with experience in many states. In Georgia, for example, trust fund reserves were sizeable, but those reserves were largely achieved through denying benefits to the unemployed and restricting the level of benefits. Georgia could easily have combined modest tax cuts and targeted UI program expansions, prudently reducing reserves while bringing their benefit system in line with changing labor markets and social insurance principles.[22]

---

[22] Emsellem and Lovell, "The Georgia Unemployment Insurance System: Overcoming Barriers for Low-Wage, Part-time & Women Workers," National Employment Law Project and Institute for Women's Policy Research, December 2000.

Individual state decisions add up to the national trends which were presented earlier -- declining taxes and stagnant reserves. Legislative decisions which may appear reasonable at the state level have potentially enormous implications for the national economy in a downturn. When evaluating why some state trust funds are surprisingly low given the long economic expansion, it's important to note the downward pressure from tax cuts compared to any upward pressure from the benefit side. Anything less is a variation on the theme of blaming the victim.

> *"Individual state decisions add up to the national trends which were presented earlier -- declining taxes and stagnant reserves. Legislative decisions which may appear reasonable at the state level have potentially enormous implications for the national economy in a downturn."*

How significant was the combination of tax cuts and changes due to experience rating? Appendix 5 shows how much more funding the trust funds would have if 1994 tax rates were applied to payrolls from 1995 to 2000.[23] Nationwide, there would be $47.7 billion more in the UI trust funds. At 1999 average benefit levels and average durations, that would provide income support to over 11 million more unemployed workers.

As this brief summary of recent history shows, it is not safe to assume that tax cuts only occur where trust fund reserves are high. On the contrary, one of the states which has among the lowest trust fund reserves — New York — is also proposing one of the largest tax cuts.[24] The willingness to allow lower and lower reserves is part of a long term change in state financial strategies. In the early years of the program, states maintained large reserves and taxes fluctuated less with economic conditions. In recent years, states have maintained lower reserves while allowing tax rates to respond more quickly to changing trust funds. Figure 9 showed changing trust fund reserves over time, illustrating the significant decline in state reserves since the early years of the UI system.

It has been argued that lower reserves are rational when linked to more responsive, flexible finance systems. But the low-reserve/ high-flexibility strategy has at least five weakness:

■   First, they are vulnerable to political decisions which allow the tax reductions to occur automatically but circumvent the automatic increases in taxes.

■   Second, low reserves make benefit-side improvements more difficult to achieve because they are always linked to the need to find "new" money.

■   Third, some states are making troubling decisions about how their systems should respond when reserves drop. "Flexibility" has many meanings. When states link low reserves to automatic benefit cuts or tax surcharges, the goal of flexibility may conflict with other central goals of the system. North Dakota now links benefit levels to a

---

[23] These calculations simply multiply 1995 to 2000 payrolls by 1994 tax rates on total wages to illustrate the scale of the change. They are not the result of macroeconomic modeling.

[24] Card and Levine recently analyzed what they called a "politically motivated" benefit enhancement. "Extended Benefits and the Duration of UI spells: Evidence from the New Jersey Extended Benefit Program," Journal of Public Economics, 78, 2000. We have yet to see any mainstream analysis of recent tax cuts which adopts the phrase "politically motivated".

comparison of state tax revenue and national average tax revenue. Oklahoma links benefit durations to trust fund reserves. In these and other cases, the financial side of the program is driving the social insurance side instead of the other way around.

- ■ Fourth, the low-reserve/high-flexibility strategy puts a premium on economic forecasts. The system is less robust in the face of large changes. The fact that 22 states had to borrow in 1982 suggests that forecasting is, at best, an imperfect art and the stakes for miscalculation can be high.

- ■ Finally, it is possible to construct a financing system with exceptionally low reserves and extremely large, temporary tax increases to replenish lost funds during downturns. But such a system would risk raising taxes in a recession — an outcome contrary to the counter-cyclical goal of the system.

The tax cut mania of the 1990s puts a fine point on the first point raised above. When it comes to tax regimes, what goes up must come down, but what goes down may not come up! That is, it can be politically tempting to allow the system to function automatically when it reduces taxes, but step in to circumvent the formula when the time comes for taxes to rise again.

> *"In these and other cases, the financial side of the program is driving the social insurance side instead of the other way around."*

The fact that so many states cut taxes despite relatively low trust funds shows how real this pressure can be. Moreover, the 1990s changed the terms of debate in UI circles when taxes were cut despite low reserves. As one activist put it, the business community cannot have it both ways. They cannot advocate for tax cuts despite low reserves while claiming benefit improvements are impossible given low reserves.[25] The rash of tax cuts was pursued as if trust fund reserves were not an issue. By the same token, expanding eligibility or raising benefits should also be feasible at lower reserves. The difference, of course, is that UI claimants pay the price for miscalculation while employers benefit — at least temporarily — from optimistic miscalculations.

It is a precarious approach to an insurance system. In contrast, a system based on first principles would balance three aspects of the system. It would estimate the cost of wage insurance sufficient to meet the challenge of a changing economy. It would incorporate a tax regime which includes reserves substantial enough to avoid spikes in taxes and a tax array progressive enough and delayed enough to avoid pro-cyclical pressures. And when all that was in place, it would index both the benefit and tax side of the system to keep the wage insurance function in synch with economic conditions.

---

[25] Calvo, "Parental Leave as Unemployment," <u>State Legislatures</u>, October/November 2000, p. 28.

State Policy Reforms

Having said how a rational system would be constructed, it's important to note that most states have, in fact, evolved along the lines described. Trust funds have grown with the booming economy, despite tax cuts in some states. If states where waiting for an opportune time to make progressive changes in their UI benefit systems, now is the time. It is difficult to imagine a more auspicious environment for creativity and forward thinking.

Another helpful comparison involves dividing states into four categories depending upon access to benefits in each state and trust fund reserves. Appendix 6 shows where the states fall when divided between trust fund reserve levels and access levels. The columns divide the state between "low" and "high" reserve states, with the threshold being an Average High Cost Multiple of 1.0 or higher (the solvency threshold recommended by the Advisory Council on Unemployment Compensation). The rows are divided between "high" and "low" rates of unemployed receiving benefits. This division is relative. Half the states are in the "high" column and half in the "low" column. The fact is, the states in the "high" category are only high compared to other states -- a modest achievement. This outcome measure is short-hand for the range of practices which reduce access to benefits among the unemployed.

Low Reserves/Below Average Recipiency

States with low reserves and low percentages of the unemployed receiving benefits should be discussing combinations of policies which expand access to benefits and improve the functioning of their tax systems. Legislators and activists in these states should consider comprehensive responses to system reform. On the finance side, they should be looking at higher taxable wage bases, indexed to inflation or to some percentage of average covered wages. Something is amiss when a state is providing wage insurance to relatively few unemployed workers while carrying insufficient reserves after over 100 months of national economic expansion.

Low Reserves/Above Average Recipiency

States with low reserves and high percentages of the unemployed receiving benefits should examine their tax systems in anticipation of future economic conditions. They might consider surcharges triggered by low trust fund reserves. Such responses are easier to pass through legislatures now, when the industries or employers who will pay the surcharge are not yet identified. Has their taxable wage base kept pace with changing wage rates? Is their experience rating complete enough to avoid inequities? Will the tax array provide rapid trust fund repayment without risking pro-cyclical pressures? Again, the peak of the business cycle is a good time to be reviewing tax issues in states with relatively low reserves. Where low reserves are the result of tax cuts in the 1990s, it is time to step back and look at the big picture. It may be that previous decisions need to be reversed with an eye toward longer-term goals and social insurance principles.

High Reserves

States with healthy trust funds and well-constructed tax systems are in a strong position to move into the next century, whether they are low or high recipiency rate states. States such as Florida, Georgia, New Mexico, New Hampshire, and Virginia can clearly afford less austere programs. They should be looking at the benefit side of their systems to correct inequities or to bring their programs more in line with the new economy. Four general approaches might be advanced in states with healthy finance systems. These four expansions are not listed as priorities; they are simply listed. First, improve benefit levels to promote higher wage replacement rates, particularly among low-income workers. Second, review eligibility provisions to promote access among workers who have been disenfranchised by restrictions or outdated thresholds. Third, pursue reforms to bring UI program elements in line with new economic environments. This could include program expansions which overwhelmingly benefit women, like domestic violence provisions or family leave. Finally, develop specific reforms targeting those most in need of income support during difficult, lengthy transitions, namely, dislocated workers.[26] In short, it is difficult to imagine a state program which addresses all these potential shortcomings.

Conclusions

As this is written, the remarkable economic expansion which the country has enjoyed since 1992 is showing signs of slowing down. This is a rare moment in economic history. Standing at what may prove to be the peak of an historically long business cycle, state legislatures and advocates should be making overdue changes in their tax and benefit systems, taking advantage of large reserves where they exist and addressing systemic problems where reserves have not responded to economic growth. They should review practices which exclude claimants from benefits, adopt reforms to bring their benefit systems in line with new economic realities, and index their benefit and tax structures to promote consistent wage insurance.

Whether seeking greater restrictions or greater access, critics of the US unemployment insurance system are quick to point out its roots in Depression-era economic realities. From right and left, critics call for system reform in line with the "new" economy. Now is the time to address these criticisms and rebuild the national wage insurance system, starting with a benefit system which acknowledges the economic realities of 21st century labor markets and a foundation of progressive taxation. After over 100 months of economic expansion, there may never be a better time.

---

[26] The National Employment Law Project is creating a fact sheet on these programs. See http://www.nelp.org.

Appendices

State Taxable Wage Bases (2001)

Alabama	$ 8,000
Alaska	$25,500
Arizona	$ 7,000
Arkansas	$ 9,000
California	$ 7,000
Colorado	$10,000
Connecticut	$15,000
Delaware	$ 8,500
District of Columbia	$ 9,000
Florida	$ 7,000
Georgia	$ 8,500
Hawaii	$28,400
Idaho	$25,700
Illinois	$ 9,000
Indiana	$ 7,000
Iowa	$17,900
Kansas	$ 8,000
Kentucky	$ 8,000
Louisiana	$ 7,000
Maine	$12,000
Maryland	$ 8,500
Massachusetts	$10,800
Michigan	$ 9,500
Minnesota	$20,000
Mississippi	$ 7,000
Missouri	$ 7,000
Montana	$18,200
Nebraska	$ 7,000
Nevada	$20,300
New Hampshire	$ 8,000
New Jersey	$22,100
New Mexico	$15,200
New York	$ 8,500
North Carolina	$14,700
North Dakota	$17,000
Ohio	$ 9,000
Oklahoma	$10,100
Oregon	$25,000
Pennsylvania	$ 8,000
Puerto Rico	$ 7,000
Rhode Island	$12,000
South Carolina	$ 7,000
South Dakota	$ 7,000
Tennessee	$ 7,000
Texas	$ 9,000
Utah	$21,400
Vermont	$ 8,000
Virginia	$ 8,000
Washington	$26,600
West Virginia	$ 8,000
Wisconsin	$10,500
Wyoming	$14,100

Source: Commerce Clearinghouse, Unemployment Insurance Reports with Social Security, No. 327 (January 2, 2001).

Appendix 2

Example of a State Tax Array: Vermont

Rate	Schedule 1	2	3	4	5
0	.4%	.6%	.8%	1.1%	1.3%
1	.5	.7	.9	1.2	1.5
2	.6	.8	1.1	1.4	1.8
3	.7	.9	1.4	1.7	2.1
4	.8	1.1	1.7	2.0	2.4
5	.9	1.4	2.0	2.3	2.7
6	1.1	1.7	2.3	2.6	3.0
7	1.4	2.0	2.6	2.9	3.3
8	1.7	2.3	2.9	3.2	3.6
9	2.0	2.6	3.2	3.5	4.0
10	2.3	2.9	3.5	3.8	4.4
11	2.6	3.2	3.8	4.1	4.8
12	2.9	3.5	4.1	4.5	5.2
13	3.2	3.8	4.4	4.9	5.6
14	3.5	4.1	4.7	5.3	6.0
15	3.8	4.4	5.0	5.7	6.4
16	4.1	4.7	5.3	6.1	6.8
17	4.4	5.0	5.6	6.5	7.2
18	4.7	5.3	5.9	6.9	7.6
19	5.0	5.6	6.2	7.3	8.0
20	5.4	5.9	6.5	7.7	8.4

Source: Vermont Unemployment Compensation Law, Title 21, Chapter 71, Section 1326(e)

Appendix 3

Measures of State Trust Fund Solvency (4th Quarter, 2000)

STATE	Revenues (000) (Last 12 Months)	TF Balance (000)	TF as % of Total Wages*	AHCM+	HCM*	Months of Current Benefits in TF
United States	**$20,754,685**	**$54,054,393**	**1.4**	**0.9**	**0.6**	**31.6**
Alabama	$162,153	$417,414	1.0	0.6	0.4	24.0
Alaska	$120,683	$219,199	3.2	1.0	0.7	22.4
Arizona	$178,215	$1,002,874	1.6	1.6	0.7	77.7
Arkansas	$185,455	$267,932	1.1	0.7	0.4	17.1
California	$2,980,750	$5,803,711	1.1	0.8	0.5	28.9
Colorado	$193,690	$786,693	1.1	1.0	0.9	60.2
Connecticut	$330,742	$848,635	1.3	0.9	0.4	31.6
Delaware	$62,402	$329,857	2.6	2.0	1.0	59.6
District of Columbia	$103,886	$259,088	1.4	1.0	0.7	44.5
Florida	$422,920	$2,029,755	1.1	1.4	0.6	37.6
Georgia	$142,542	$1,906,548	1.7	1.7	0.8	72.0
Hawaii	$146,489	$315,028	2.6	1.5	1.2	35.8
Idaho	$95,076	$277,848	2.2	0.9	0.7	32.3
Illinois	$1,146,581	$2,091,829	1.1	0.5	0.4	20.5
Indiana	$288,638	$1,605,598	2.1	1.5	1.2	64.2
Iowa	$180,768	$823,519	2.5	1.2	1.0	45.4
Kansas	$147,137	$495,977	1.4	0.9	0.7	33.9
Kentucky	$256,715	$700,183	1.7	0.7	0.6	30.5
Louisiana	$123,864	$1,511,999	3.6	1.3	1.2	96.9
Maine	$154,080	$339,578	2.7	1.4	0.9	52.9
Maryland	$293,363	$882,505	1.3	0.9	0.6	40.5
Massachusetts	$865,908	$2,131,041	1.7	1.0	0.5	31.7
Michigan	$1,049,742	$3,067,381	2.1	0.7	0.6	39.6
Minnesota	$367,620	$720,226	1.0	0.6	0.5	21.1
Mississippi	$119,061	$695,793	3.0	1.9	1.5	67.2
Missouri	$253,841	$484,904	0.7	0.6	0.4	17.9
Montana	$56,664	$181,697	2.5	1.5	0.8	39.4
Nebraska	$45,969	$179,177	0.9	1.0	0.6	39.3
Nevada	$217,817	$507,514	1.8	1.1	0.7	29.8
New Hampshire	$31,927	$328,233	1.8	2.0	0.7	151.1
New Jersey	$1,327,073	$3,086,440	2.1	1.1	0.6	32.1
New Mexico	$88,609	$561,517	3.9	2.8	2.4	90.3
New York	$1,989,150	$1,204,694	0.4	0.3	0.2	8.9
North Carolina	$310,345	$1,174,664	1.2	0.9	0.5	28.1
North Dakota	$39,207	$33,053	0.6	0.3	0.3	11.5
Ohio	$663,276	$2,235,972	1.5	0.6	0.5	37.3
Oklahoma	$52,828	$571,571	1.8	1.4	1.3	61.7
Oregon	$528,817	$1,558,005	3.7	1.5	1.1	43.8
Pennsylvania	$1,491,285	$2,865,076	1.9	0.7	0.6	22.9
Puerto Rico	$196,847	$534,513	3.9	1.2	0.9	29.3
Rhode Island	$152,227	$292,892	2.6	0.9	0.6	26.8
South Carolina	$177,229	$782,242	1.8	1.3	0.6	46.7
South Dakota	$14,113	$51,445	0.7	0.8	0.7	44.7
Tennessee	$296,147	$883,170	1.3	0.9	0.6	28.8
Texas	$1,029,504	$742,276	0.3	0.3	0.2	8.7
Utah	$65,584	$625,569	2.5	1.6	1.3	76.8
Vermont	$51,799	$305,443	4.7	2.5	1.5	80.7
Virginia	$154,875	$1,067,516	1.1	1.3	0.8	68.4
Washington	$969,790	$1,963,544	2.3	1.0	0.6	26.6
West Virginia	$136,436	$222,839	1.6	0.5	0.4	23.0
Wisconsin	$460,275	$1,834,982	2.7	1.1	0.9	40.3
Wyoming	$24,837	$186,565	4.1	1.6	1.3	89.7

+ Refers to most recent calendar year. Fourth and first quarter issues publish measure based on extrapolated wages;
Second and third quarter issues publish measure based on actual wages.

* Based on extrapolated wages for the most recent 12 months.

Source: US Department of Labor, "UI Data Summary", Fourth Quarter 2000.

UI Tax Rates as a Percentage of Total Wages by State (1994-2000)

	1994	1995	1996	1997	1998	1999	2000
United States	0.92%	0.86%	0.78%	0.70%	0.62%	0.57%	0.54%
Alabama	0.36%	0.37%	0.34%	0.34%	0.44%	0.39%	0.42%
Alaska	1.66%	1.71%	1.77%	1.88%	1.63%	1.65%	1.42%
Arizona	0.61%	0.61%	0.52%	0.47%	0.38%	0.32%	0.25%
Arkansas	0.95%	0.88%	0.83%	0.83%	0.81%	0.78%	0.81%
California	0.98%	0.96%	0.94%	0.76%	0.66%	0.62%	0.62%
Colorado	0.53%	0.47%	0.40%	0.38%	0.33%	0.32%	0.34%
Connecticut	1.21%	1.26%	1.23%	1.18%	1.10%	0.66%	0.53%
Delaware	0.83%	0.86%	0.72%	0.68%	0.56%	0.55%	0.53%
Dist. of Columbia	1.03%	0.92%	0.79%	0.50%	0.54%	0.56%	0.53%
Florida	0.65%	0.58%	0.50%	0.45%	0.32%	0.34%	0.25%
Georgia	0.56%	0.48%	0.45%	0.37%	0.30%	0.15%	0.15%
Hawaii	0.76%	1.60%	1.46%	1.33%	1.25%	1.23%	1.25%
Idaho	0.95%	0.92%	1.21%	0.92%	0.77%	0.73%	0.81%
Illinois	1.10%	1.01%	0.78%	0.73%	0.68%	0.64%	0.63%
Indiana	0.42%	0.41%	0.38%	0.39%	0.32%	0.37%	0.44%
Iowa	0.69%	0.51%	0.51%	0.50%	0.50%	0.50%	0.62%
Kansas	0.76%	0.16%	0.12%	0.13%	0.13%	0.13%	0.53%
Kentucky	0.78%	0.75%	0.72%	0.72%	0.68%	0.63%	0.53%
Louisiana	0.70%	0.64%	0.57%	0.54%	0.48%	0.42%	0.44%
Maine	1.45%	1.27%	1.23%	1.03%	1.13%	1.12%	1.16%
Maryland	1.18%	1.08%	0.77%	0.54%	0.48%	0.48%	0.44%
Massachusetts	1.53%	1.43%	1.31%	1.30%	0.94%	0.76%	0.72%
Michigan	1.46%	1.34%	1.09%	0.98%	0.80%	0.77%	0.81%
Minnesota	0.94%	0.79%	0.66%	0.60%	0.55%	0.51%	0.53%
Mississippi	0.85%	0.77%	0.48%	0.43%	0.50%	0.56%	0.53%
Missouri	0.94%	0.70%	0.66%	0.61%	0.55%	0.43%	0.44%
Montana	0.95%	0.95%	0.87%	0.86%	0.86%	0.87%	0.81%
Nebraska	0.31%	0.27%	0.30%	0.34%	0.14%	0.18%	0.25%
Nevada	0.91%	0.89%	0.89%	0.84%	0.81%	0.81%	0.82%
New Hampshire	0.72%	0.48%	0.31%	0.20%	0.20%	0.18%	0.25%
New Jersey	0.83%	0.87%	1.16%	1.14%	0.96%	0.82%	0.72%
New Mexico	0.86%	0.72%	0.72%	0.74%	0.75%	0.63%	0.63%
New York	1.10%	1.02%	0.94%	0.84%	0.61%	0.56%	0.72%
North Carolina	0.34%	0.28%	0.10%	0.31%	0.35%	0.36%	0.35%
North Dakota	0.65%	0.61%	0.45%	0.46%	0.59%	0.62%	0.82%
Ohio	0.95%	0.91%	0.76%	0.54%	0.51%	0.46%	0.53%
Oklahoma	0.53%	0.49%	0.40%	0.32%	0.17%	0.18%	0.15%
Oregon	0.96%	0.85%	1.28%	1.23%	1.24%	1.26%	1.33%
Pennsylvania	1.72%	1.57%	1.27%	1.13%	1.07%	1.01%	1.09%
Puerto Rico	1.51%	1.52%	1.56%	1.53%	1.44%	1.36%	0.72%
Rhode Island	2.09%	2.07%	2.05%	2.00%	1.85%	1.55%	1.41%
South Carolina	0.64%	0.63%	0.62%	0.60%	0.42%	0.41%	0.44%
South Dakota	0.21%	0.21%	0.20%	0.21%	0.21%	0.20%	0.25%
Tennessee	0.59%	0.55%	0.50%	0.46%	0.46%	0.43%	0.44%
Texas	0.62%	0.60%	0.52%	0.47%	0.43%	0.38%	0.44%
Utah	0.59%	0.55%	0.50%	0.42%	0.36%	0.27%	0.34%
Vermont	1.10%	0.95%	0.91%	0.89%	0.85%	0.84%	0.81%
Virginia	0.48%	0.45%	0.36%	0.26%	0.17%	0.16%	0.15%
Washington	1.22%	1.16%	1.10%	1.19%	1.19%	1.17%	1.25%
West Virginia	1.12%	1.08%	1.06%	1.03%	1.01%	1.00%	1.09%
Wisconsin	0.90%	0.84%	0.79%	0.74%	0.68%	0.68%	0.72%
Wyoming	0.74%	0.73%	0.72%	0.75%	0.74%	0.55%	0.72%

Source: U.S. Department of Labor, Office of Workforce Security

Appendix 5

UI Tax Contributions in the United States: A Comparison of Actual Yearly Totals with Estimated Totals Based on the 1994 Average UI Tax Rate
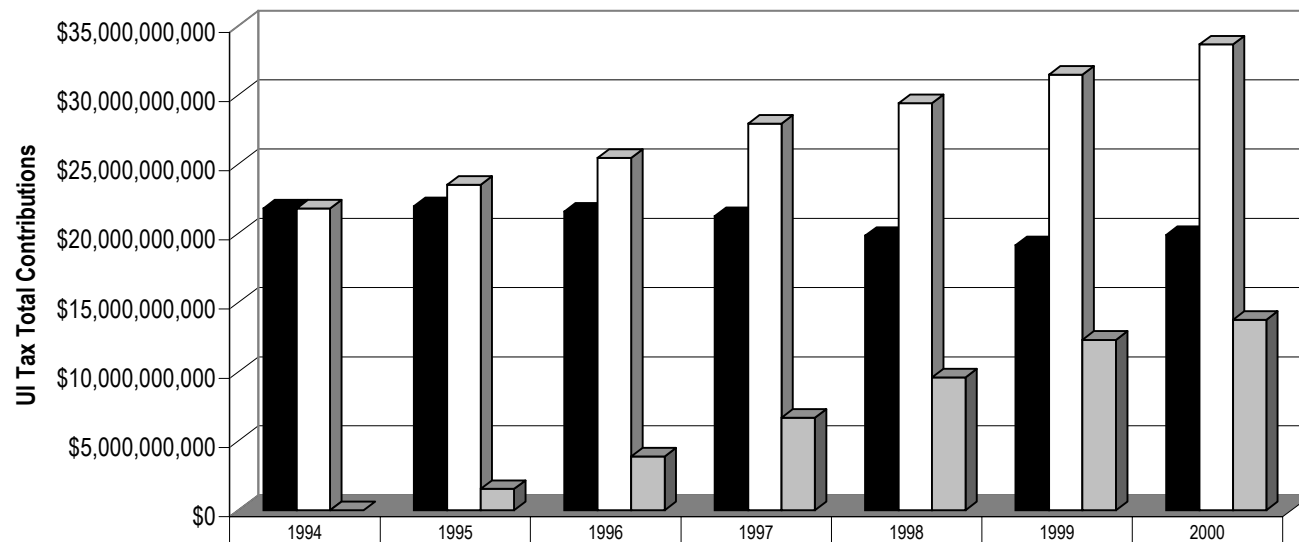
	1994	1995	1996	1997	1998	1999	2000
■ Actual UI Contributions	$21,802,069,000	$21,970,828,000	$21,577,968,000	$21,247,040,000	$19,825,155,000	$19,153,840,000	$19,897,103,000
☐ Estimated UI Contributions (based on the 1994 rate as a percentage of total wage (.92%))	$21,802,069,000	$23,503,676,465	$25,450,936,615	$27,924,681,143	$29,417,971,935	$31,467,022,857	$33,649,512,426
▨ Difference between the Actual and Estimated UI Contributions ($47,741,867,442)	$0	$1,532,848,465	$3,872,968,615	$6,677,641,143	$9,592,816,935	$12,313,182,857	$13,752,409,426

Year

Source: U.S. Department of Labor, Office of Workforce Security

Appendix 6

Matrix of State Fund Balances and Unemployed Receiving Benefits, 4th Quarter 2000

		Average High Cost Multiple	
		Low (AHCM <1.0)	High (AHCM => 1.0)
Percentage of the Unemployed Receiving Benefits	Low (<40%)	Alabama Idaho Illinois Kansas Kentucky Maryland Minnesota Nebraska New York North Dakota Ohio South Dakota Texas West Virginia United States Average	Arizona Colorado Delaware DC Florida Georgia Hawaii Louisiana Maine Mississippi Montana New Hampshire New Mexico Oklahoma Virginia Utah Wyoming
	High (=>40%)	Arkansas California Connecticut Michigan Missouri North Carolina Pennsylvania Rhode Island Tennessee	Alaska Indiana Iowa Massachusetts Nevada New Jersey Oregon South Carolina Vermont Washington Wisconsin

Source: US Department of Labor, "UI Data Summary", Fourth Quarter 2000.

Note: Several of the states (four out of nine) listed above as providing benefits to more than 40 percent of the unemployed while also falling below the AHCM of 1.0 are, in fact, close to the solvency level at 0.9 AHCM (see Appendix 3).