

—Briefing Paper—



National Employment Law Project

Unemployment Insurance Financing:
EXAMINING STATE TRUST FUNDS FACING RECESSION

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May 2008

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Executive Summary

- At the start of 2008, state unemployment insurance (UI) trust funds had an overall balance of \$38.3 billion. In comparison, states entered the recession in 2001 with \$54.05 billion in UI trust fund reserves, an amount that was also below accepted levels of pre-recession solvency. Overall, states currently have UI reserves that are roughly half the levels recommended prior to a recession.
- A detailed analysis of individual state UI trust fund solvency indicators shows that some have built ample reserves while several have failed to prepare for recession. Based upon past recessions, we estimate that as many as 18 states will face financing challenges in any future recession or downturn, depending upon the depth and duration of the slowdown. See Table 1.
- Thirteen states have 4th quarter 2007 reserve ratios (percent of total wages held as trust fund reserves) over 2.0 and average high cost multiples (AHCMS) over 1.0 (AK, HI, ME, MS, MT, NM, OK, OR, PR, UT, VT, WA, WY). These states have adequate reserves to face a moderate recession without worrying about UI trust fund pressures. Another 8 states are near recommended levels of pre-recession solvency (AZ, DC, FL, LA, NE, NV, NH, VI).
- Four states, Michigan, Missouri, New York, and Ohio, face immediate UI trust fund solvency challenges in 2008. Another 14 states (AR, CA, IL, IN, KY, MN, NC, NJ, PA, SC, SD, TN, TX, WI) could join this group if the job slump continues or their UI payroll taxes don't rise to meet the demands created by higher UI claims.
- A number of states with solvent UI trust fund reserves have serious shortcomings in their UI programs. These states stand out as highly solvent jurisdictions with inadequate benefit levels and/or below average levels of UI reciprocity. A good number of these states lack key UI reform measures that can increase eligibility or benefit levels and bolster UI safety nets without negatively impacting overall state trust fund solvency.
- Recommended reforms that have been adopted in a number of states include the alternative base period (ABP), part-time UI eligibility, and recognizing expanded reasons for good cause for leaving work. The cost of these reforms is modest and affordable even in states with lower levels of reserves.
- Maintaining or restoring UI trust fund solvency requires that states have policies that provide for forward funding of their UI programs. Recommended policies are raising and indexing taxable wage bases, having adequate maximum UI payroll tax rates, and setting minimum tax rates above zero.



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Introduction

With a recession or economic slowdown now underway, state unemployment insurance (UI) trust funds face higher claims levels and longer benefit durations that accompany any economic downturn. This briefing paper discusses how to judge the adequacy of a state's UI trust fund balance and reviews UI trust fund reserves of every state at the end of 2007. After explaining some of the basics of understanding UI solvency, our paper examines the adequacy of states' trust fund reserves as we face an economic recession or slowdown. We also discuss the need for basic UI reform measures even in a context of greater financial pressure on state UI trust funds.

Basic Terminology of UI Solvency

Evaluating the sufficiency of unemployment insurance (UI) trust funds involves making a judgment regarding the "solvency" of UI trust fund balances—basically a judgment about the level of reserves required to meet UI benefit requirements in a future downturn.¹ In order to understand solvency discussions, policymakers and advocates for jobless workers need to understand some basic terminology. Information in the box below explains the basic terminology used here in discussing UI solvency.

There are two basic perspectives on UI solvency. Comparing trust fund reserves to each state's total wages is a way to measure trust fund balances against the amount of a state's wages. This measure is usually called the "reserve ratio" and is a way of looking forward at the potential size of claims against the trust fund. The other common measure of solvency compares the size of trust fund reserves to past benefit payouts during recessions. Termed a "cost multiple," this measure of solvency uses past performance to assess the adequacy of current reserves. In addition to these basic solvency measures, economists and state agencies make their own projections of future benefit payments and UI payroll tax revenues to judge whether state trust fund balances are at prudent levels. Of these two measures, we use the Average High Cost Multiple (AHCM) frequently in this paper. See the box below for detailed explanations of these terms.

Understanding Three Basic Measures for UI Trust Fund Solvency

The following terms are commonly used to analyze UI trust fund solvency:

The Reserve Ratio or Trust Fund as Percent of Total Wages is a state's trust fund balance as a percent of that state's total wages for the past 12 month period. Trust fund reserves are compared with state wages, roughly comparing the size of the trust fund balance to the risk being insured by UI (loss of wages). Reserve ratios are useful solvency measures because they reflect the size of a state's economy. There is no accepted reserve ratio standard accepted among UI solvency experts, although a pre-recession reserve ratio of at least 2.0 is wise in our view.² Table 2 at the end of this paper helps compare the situation in 2008 to the situation in 2000, just prior the most recent recession. Indicators from the end of the 4th calendar quarter of 2007 are compared to same period of 2000. The most recent recession was officially dated as starting in March 2001.

Cost multiples compare the size of past UI benefit payments amounts in a twelve-month period to trust fund balances. There are two cost multiple benchmarks in common use.

A High Cost Multiple (HCM) of 1.0 means that a state has one year's reserves at its historically highest level of benefit payments without relying upon UI payroll tax revenues. An HCM of 0.5 converts to six months, an HCM of 1 equals 12 months, and so forth. In the 1950s, an HCM of 1.5 (or 18 months) was widely accepted as a prudent level of pre-recession UI reserves.

The Average High Cost Multiple (AHCM) was adopted in the 1990s in light of concern that HCMs were overly conservative measures of solvency. A state's AHCM is the average of the three most recent high cost calendar years that include either three recessions or at least 20 years history. The Advisory Council on Unemployment Compensation, a federal advisory panel, recommended in 1995 that states maintain a pre-recession AHCM of 1.0.³ Table 2 at the end of this paper provides AHCMs for each state as of the close of 2007.

Cautionary Note: The total dollars found in a state's UI trust fund, in and of itself, tells an observer little about the trust fund's ability to carry a state through a recession.

Thinking about State UI Trust Fund Solvency and Forward Financing

Entering the current recession, states had \$38.3 billion in trust fund reserves (see Table 2).⁴ The national reserve ratio was 0.8 and the U.S. AHCM was 0.52, both well below recommended levels of pre-recession trust fund solvency levels. (As discussed in the box above, NELP recommends a pre-recession reserve ratio of 2.0 and many observers recommend a pre-recession AHCM of 1.0—which translates to 12 months of benefit payments without relying upon current revenues.) So, in summary, we can say that overall state UI trust fund reserves fall below recommended levels at the beginning of 2008, and that state funds as a group are currently in a less advantageous position than they were prior to the 2001 recession.

The twin goals of unemployment insurance are payment of adequate temporary wage replacement to involuntarily unemployed individuals and stimulation of economic activity by maintaining consumer spending. Wayne Vroman, our nation's leading authority on UI financing, summarizes the overall economic theory supporting forward funding of UI programs:

Trust fund balances are built up before recessions, drawn on during recessions, and then rebuilt during the subsequent recoveries. The funding arrangement implies that the program acts as an automatic stabilizer of economic activity, that it makes larger benefit payments than tax withdrawals during recessions and larger tax withdrawals than benefit payments during economic expansions.⁵

Obviously, paying adequate benefit levels to a reasonable proportion of jobless workers translates to making state UI programs more effective countercyclical mechanisms. In contrast, keeping UI payroll taxes and trust fund levels as low as possible during economic good times and then raising taxes and cutting benefits due to financial stress during recessions turns the economic impact of UI programs on their head. State UI trust funds work best when they build up reserves during periods of economic growth and then rely upon those reserves to moderate or avoid UI payroll tax increases and/or UI benefit restrictions during economic recessions.

Despite what tradition, prudence and fiscal conservatism should teach about forward funding of unemployment insurance trust funds, since the mid-1980s a number of states have moved their UI financing mechanisms toward what we have termed "pay as you go" financing.⁶ Under these arrangements, states no longer focus on staying solvent under the traditional UI solvency measures we have discussed here. Instead, pay as you go states (explicitly or implicitly) adopt financing mechanisms that are designed to raise and lower tax levels and benefit payment levels as trust fund balances rise and fall over the business cycle. These states explicitly trade off building trust fund reserves for the supposedly greater economic good offered by lower UI payroll taxes.

For many reasons, pay as you go is a bad policy for jobless workers, in our experience. In terms of economics, pay as you go financing perversely stimulates a state's economy with lower taxes while the economy is good, then raises taxes when the economy worsens. As Vroman has observed, "To impose added economic burdens on the parties during a recession, i.e., reduced benefits and higher taxes, seems inappropriate to many."⁷ Worse still, in our view, pay as you go financing either reduces UI benefits or creates pressure for UI benefit restrictions in the event that UI solvency reaches less than desirable levels, threatening critical support for jobless workers when they need it the most.

States that have statutory pay as you go arrangements include Illinois, Ohio, Pennsylvania, Minnesota, and Texas. Other states have less open pay as you go approaches that effectively amount to abandoning forward financing, as in Michigan and Massachusetts, where the Legislatures have cut UI payroll taxes repeatedly since the 1990s.

Current low balances in many states' trust funds demonstrate that states have frequently found it more politically palatable to neglect state UI trust fund solvency than to address UI financing policy unless they are forced to do so, regardless of whether they have formally adopted pay as you go financing mechanisms. The solvency performance of states during the most recent recession, combined with the fact that states overall are not as solvent at the outset of the current downturn, indicates that rough sledding is ahead in several states during the oncoming recession. If a serious recession happens in 2008 and 2009, it is likely based upon patterns from the past two recessions that as many as 12 to 18 states will face solvency challenges.

How Pre-Recession Solvency Helps States Avoid Financing Trouble

State UI trust funds had a higher level of solvency prior to the 2001 recession than they currently have as they again face recession in 2008. At the onset of the 2001 downturn, states had \$54.05 billion in UI trust fund reserves, providing a national reserve ratio of 1.4 and an average high cost multiple (AHCM) of 0.9. In other words, overall state UI reserves were somewhat below recommended levels prior to the 2001 recession, but not as low as states are currently situated when judged on these traditional solvency measures.⁸ See Table 2.

The 2001 recession was mild compared to many post-WWII recessions, but it nevertheless illustrates how quickly higher UI benefit costs can translate to financial trouble for state UI trust funds in a downturn. During a recession, even modest increases in overall unemployment rates translate into significant increases in benefit payments as more claims are filed and duration of UI claims increases. For example, in the 4th quarter of 2000, the U.S. average duration of UI claims was 13.7 weeks. By the 4th quarter of 2002, duration of claims had risen to 16.5 weeks. The numbers of claims rose as well. In FY 2000 (10/01/99 to 9/30/00) there were 6.8 million UI benefit recipients. In both FY 2002 and FY 2003, UI recipients exceeded 10 million individuals annually. As a result of these increases in claims and duration, state UI benefit

payments rose from \$20 billion in FY 2000 to \$42 billion in both FY 2002 and 2003. State reserves fell \$30 billion to around \$20 billion by the end of 2003.

The performance of states during the most recent recession shows that pre-recession solvency levels are closely related to financing difficulties during downturns. Wayne Vroman's review of the 2001 recession's impact on UI trust funds finds that nine states (CA, IL, MA, MN, MO, NY, NC, PA, TX) borrowed or issued bonds to maintain trust fund solvency during the 2001 recession or its wake, and another six states had low reserves but avoided borrowing (AR, CO, CT, MI, OH, VA). Five of these 14 states passed some sort of solvency legislation (IL, MA, MN, MO, TX).⁹ And, none of these 14 states with solvency challenges in the wake of the last recession had pre-recession reserves that met recommended levels of a reserve ratio of 2.0 or more combined with an AHCM of 1.0 or more. See Table 2.

Another factor differentiates the solvency impact of any coming recession from the experience of states in the most recent recession. State trust funds in the relatively mild 2001 recession benefited from a distribution of \$8 billion in federal "Reed Act" funds in March 2002. This amounted to about 20 percent of overall state trust fund reserves at these federal funds were distributed. Most states did not use the funds to extend UI benefits or eligibility, but instead left them in their trust funds to bolster reserves and, as a result, reduced state UI payroll taxes or avoided increasing UI payroll taxes on employers.¹⁰ In the absence of a similar federal Reed Act distribution in the current downturn, we can expect greater financial difficulties for the less solvent states during the coming recession. At the current time, there is no movement to provide a Reed Act distribution, and based upon the pattern set by states after the last distribution, we would not be in support of any unilateral action to assist imprudent states with federal UI financing assistance.

Why Are Most States Less Solvent Now Than Prior to the 2001 Recession?

National AHCMs began the 2001 recession at 0.91 at the end of FY 2001, fell to 0.36 in FY 2005, and only recovered to 0.51 by the end of FY 2007. A review of Table 2 shows that only nine states (AK, DC, HI, KS, ME, MT, NE, OK, WA) entered 2008 with higher AHCMs than their AHCM levels at the end of 2000. This observation confirms the observed decline in solvency shown by comparing U.S. reserve ratios and cost multiples at the end of 2000 to those at the end of 2007. We believe that there are a number of reasons that help explain why states' UI trust fund solvency is lower overall at the onset of the current recession than it was at the end of 2000.

First of all, the years of mid-1990s through 2000 represented a very positive and sustained period of economic growth, low unemployment, and widespread prosperity. Low levels of unemployment combined with increasing employment levels translated to lower UI benefit payments and rising UI payroll tax revenues. These factors contributed to overall UI solvency in 2000, despite the fact that individual states made irresponsible UI financing decisions during this period. Second, the early 90s recession was also not particularly severe, with only seven states experienced UI trust fund borrowing during the early 90s recession (CT, DC, ME, MA, MI, MO, NY). And, more than eight years passed between the two most recent economic downturns. This means that most states started the 1990's recovery period in a solvent condition and ended 2000 after a sustained period of recovery for their UI trust funds.

Underlying labor market conditions during the most recent recovery period following the 2001 recession have contrasted to more favorable conditions prior to that recession. These less favorable economic factors have contributed to states' currently reduced solvency levels. In contrast to the 1990s recovery period, the period since the 2001 recession was marked by four years of virtually no growth in covered employment, a factor that directly impacts on collection of UI payroll taxes. Indeed, average monthly covered taxable

employment rose steadily after the end of the early 90s recession. Overall, covered employment rose 20.7 percent from 86.85 million in CY1993 to 104.82 million in CY 2000. In contrast, during the post-2001 recovery period, average covered employment did not reach pre-recession 2000 levels again until CY 2005. In other words, covered employment levels virtually did not grow for four years during the "recovery" period of this most recent business cycle. This slow recovery in employment has definitely impacted UI payroll tax recovery.

Relatively high benefit payment levels caused by lagging job growth have also impacted state solvency. State UI benefit payments fell from their FY 2003 peak of \$42 billion, but only to \$31.41 billion in FY 2007, still remaining \$11.2 billion over pre-recession FY 2000 payment levels in 2007.

Careful examination shows that these higher payment levels are not caused by overly generous UI benefit amounts. Instead, the same labor market shifts toward more permanent layoffs and more long term unemployment are resulting in longer UI claim durations, higher exhaustion of benefits, and higher overall benefit costs. For instance, actual duration of benefits was 14.6 weeks on average in the 80s, averaged 14.9 weeks in the 90s, and has reached 15.5 weeks so far in this decade. In contrast, the relationship between average wages and average weekly UI benefits (termed the replacement ratio) has remained in a narrow range around 0.36 to 0.37 for several decades. For the 80s, the benefit replacement ratio averaged 0.359, for the 90s it was 0.346, and for the current decade it has been 0.353. For this reason, recognizing that lingering higher benefit totals over the recovery period have impeded UI solvency's return is not the same as saying that overly generous benefit payments are a valid explanation. Indeed, weekly UI benefit amounts have remained near or below their past levels of wage replacement during this decade.

Assessing Current State Unemployment Insurance Trust Fund Reserves

Although national solvency measures are below recommended levels, a more detailed examination of state trust funds shows that something less than half the states face recession with solvent trust funds, while a significant number are well below desirable solvency levels. For that reason, individual state-by-state attention is required to more fully evaluate state UI trust fund solvency.

Table 1: Summary of 2008 State UI Trust Fund Solvency

Clearly Solvent -13 States- (RR > 2.0 and AHCM > 1.0)	Adequately Solvent -8 States- (AHCM \geq 1.0 and/or RR near 2.0)	Probably Solvent -6 States- (AHCM < 1.0, but > 0.75 and RR near 1.0)
AK, HI, ME, MS, MT, NM, OK, OR, PR, UT, VT, WA, WY	AZ, DC, FL, LA, NE, NV, NH, VI	DE, GA, IA, KS, MD, ND
Less Than Solvent -8 States- (AHCM < 0.75 and >0.5 or RR > 1.1)	Near Insolvent -14 States- (AHCM < 0.5 and RR < 0.8)	Not Solvent -4 States- (AHCM < 0.2 and RR < 0.3)
AL, CO, CT, ID, MA, RI, VA, WV	AR, CA, IL, IN, KY, MN, NC, NJ, PA, SC, SD, TN, TX, WI	MI, MO, NY, OH

Table 1 shows that 13 states (AK, HI, ME, MS, MT, NM, OK, OR, PR, UT, VT, WA, WY) have trust funds that meet both recommended solvency levels with a reserve ratio over 2.0 and an AHCM over 1.0. Another eight states are near recommended solvency levels (AZ, DC, FL, LA, NE, NV, NH, VI). In contrast to these 21 states with healthy UI trust fund levels, four states are basically not solvent and have recently been borrowing to pay UI benefits or are near borrowing (MI, MO, NY, and OH). Another 14 states are well below recommended solvency levels (AR, CA, IL, IN, KY, MN, NC, NJ, PA, SC, SD, TN, TX, and WI). These 18 states will have difficulty riding out a 2008 recession without either federal borrowing or taking other solvency related actions. Another eight states (AL, CO, CT, ID, MA, RI, VA, WV) are likely to face financing difficulties, especially if the next recession is moderate to severe.

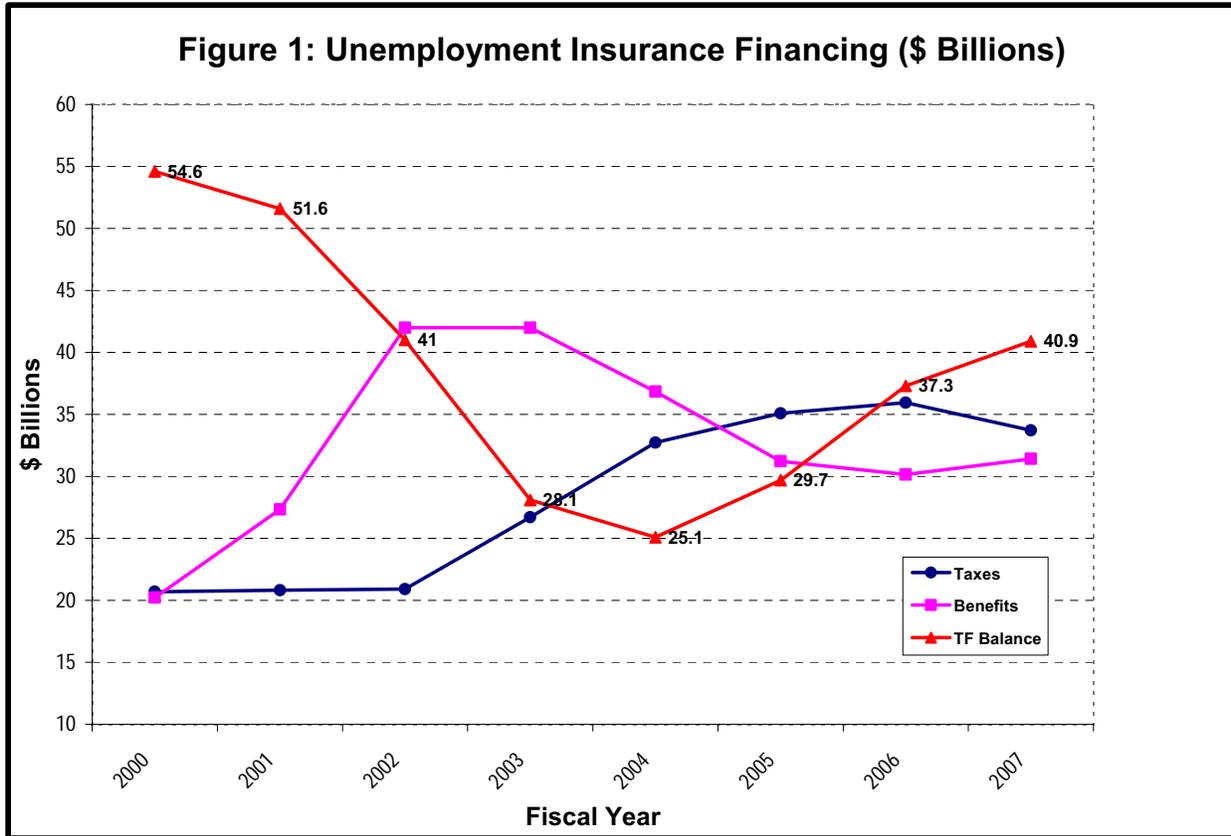
Table 1 summarizes the detailed information in Table 2 in order to help us characterize each state's specific solvency situation in facing the coming economic slowdown. Table 1 shows groupings of state trust fund balances using reserve ratios (RR) and average high cost multiples (AHCMs) for the 4th quarter of 2007. To be sure, Table 1 reflects "natural" groupings among the array of states based upon these two common solvency measures, rather than a predictive econometric model. But, based upon what happened in the past 2 recessions, Table 1 certainly shows states that are likely to experience UI financing challenges in 2008 and 2009. While not every state in the bottom 18 states in Table 1 will have solvency emergencies, many are likely to face financing issues. And, while not all the higher-ranked states will avoid solvency challenges, most of them will.

Overview of UI Financing Since the Last Recession

Ultimately, UI financing depends upon states raising sufficient payroll taxes to pay for UI benefits. During a recession, reserves provide the cushion to prevent immediate tax increases or insolvency. Figure 1 compares state UI benefit payments and revenues from the pre-recession year of FY 2001 (10/01/00 to 9/30/01) through FY 2007. As the figure shows, payments rose quickly in 2002 while payroll taxes increased more slowly, reducing trust fund balances. While state experience rating mechanisms and other steps increased revenues, these measures did not permit states to return to the pre-recession level of solvency by the end of 2007.

As illustrated by Figure 1, the bottom line on the most recent recovery period is that a significant number of states did not raise sufficient revenues to pay for increased benefit payments triggered by the 2001 recession and the timid recovery following it. For that reason, several states did not build adequate reserves to prepare for the oncoming economic downturn.

Figure 1 shows the rapid increase in benefit payments that is triggered by a recession, as well as the lagged response of state UI payroll tax mechanisms. The gap between benefits and taxes determines the decline in overall solvency. And, it is again worth noting that the 2001 recession was mild in terms of its impact on total unemployment, but this downturn quickly doubled UI benefit payments and drove less solvent states toward financing difficulties. For this reason, examining a state's UI solvency with a focus on its overall trust fund balance is not a reliable indicator of the reserve adequacy. Rather than isolating on the number of dollars in a trust fund, observers should use solvency indicators, including the reserve ratio and AHCM, when assessing trust fund solvency.



Key Role for Taxable Wage Bases in UI Financing

In addition to these economic or labor market explanations, a particularly important policy factor is contributing to reduced state trust fund solvency. This policy factor is the decreasing proportion of wages that are subject to UI taxation in many states. This is happening because each state is free to set a "taxable wage base" that is subject to state UI payroll taxes (so long as it exceeds the federally-imposed minimum of \$7000 a year). This amount sets the maximum amount of wages per employee that can be taxed. In 2008, TWBs ranged from a high of \$32,200 (ID) to nine states with TWBs of the minimum \$7000 (AZ, CA, FL, IN, LA, MS, PR, SC, TN). Another 21 states have TWBs of \$10,500 or less, meaning that 30 states have TWBs of less than \$10,500. Notably, while a majority of states have maintained low TWBs, a dozen states have TWBs over \$20,000 in 2008. Table 2.

Sixteen states automatically increase their TWBs each year by "indexing" their wage bases to state average annual wages (AK, ID, IA, MN, MT, NV, NH, NJ, NM, NC, ND, OK, OR, UT, VI, WA, WY). In all other states, legislative action is required to change TWBs.¹¹ In contrast to the relatively fixed levels of taxable wage bases, UI benefits increase automatically in step with increases in wages, since all weekly benefits are paid based upon a formula that replaces some portion of lost wages. In addition, 34 states have maximum weekly benefit caps that increase annually with growth in those states' average wages.

Indexing taxable wage bases obviously has an impact on the level of a state's TWB. All the states with TWBs near or over \$20,000 on Table 2 have indexed taxable wage bases. None of the 30 states with taxable wage bases of \$10,500 or less has indexed taxable wage bases. And, of the 13 states we identify

as "clearly solvent" going into 2008, 8 have indexed taxable wage bases (and, until this year another indexing state was Hawaii, which had an indexed taxable wage base over \$30,000 last year). And, while 3 states (MN, NC, NJ) with indexed TWBs are considered "nearly insolvent," both New Jersey and North Carolina have taken active legislative measures to cut UI payroll taxes or divert UI revenues in a way that has effectively subverted the positive solvency impacts of taxable wage base indexing. Minnesota's overall UI financing mechanism is simply not designed to produce growing fund balances, despite its adoption of an indexed taxable wage base.

Because of the growth in wages and resulting increases in maximum weekly benefits, weekly benefits rise each year without any legislative action. This growth in benefit levels can be observed by noting that in FY 1997 the national average weekly benefit amount (AWBA) was \$185. By FY 2003, it had risen to \$254, and by FY 2007 the U.S AWBA was \$276, a 49 percent increase in average weekly benefit levels over that ten year period. Over this same period, the average taxable wage base rose from \$9,825 in 1998 to \$11,482 in 2007, a 17 percent increase.

As a consequence of having mostly fixed taxable wage bases combined with growing weekly benefits levels, the ratio of taxable wages (those wages covered by state taxable wage bases) to total wages (those wages paid to covered employees) has declined. Nationally, the ratio of taxable wages to total wages was 0.447 in 1980; it reached 0.376 in 1990, and fell to 0.305 in 2000, reaching 0.279 in 2006. In other words, just over a quarter of covered wages nationally are subject to state UI payroll taxes. In some individual states with low TWBs and high wages, the ratio of taxable wages to total wages is much lower. In California (one of 9 states remaining with a minimum TWB of \$7000), total wages paid by covered employers in 2007 was \$611.9 billion, but only \$111.4 billion of those wages were taxable, meaning that California was using a TWB of less than 20 percent of total wages to finance its UI program.

The obvious impact of paying for rising UI benefit levels on a fixed taxable wage base is aptly described by economist Philip Levine. "A major deficiency in the current system of UI financing is that the infrequent, ad hoc adjustments to the taxable wage base lead to a continual erosion of its financial stability Even in the absence of severe cyclical downturns, these basic relationships indicated that the current system of UI financing will drift toward insolvency."¹² And, for the most part, this description by Levine is an accurate assessment of the current trends illustrated in the paper. State UI solvency has eroded in recent years, not so much because of specific state legislative action, but because of these underlying imbalances in state UI financing mechanisms.

Conversely, higher taxable wage bases put UI financing on a broader basis and increase the responsiveness of UI taxes when recovering from higher UI payments during a recession. Wayne Vroman has shown there is a strong correlation between TWB levels and the ability of states' UI financing mechanisms to produce sufficient revenues to maintain solvent trust fund reserves during a recession. Similarly, the Advisory Council on Unemployment Compensation found from its studies that increasing state taxable wage bases were associated with improvements in the solvency of UI trust funds, as measured by reserve ratios.¹³ NELP has also objected to equity issues raised by low taxable wage bases because they subject low-wage workers' wages to higher rates of UI payroll taxation than higher taxable wage bases.

In contrast to the economic factors contributing to reduced state solvency we have outlined above, low TWBs are policy choices made by states. Certainly, states that have less than prudent levels of UI trust fund reserves should raise their taxable wages. Employers portray taxable wage increases as tantamount

to pure tax rate increases, but overall UI tax rates can be adjusted downward to make wage base increases more revenue neutral if that is deemed desirable. The point of higher taxable wage bases from the perspective of UI financing is not so much to increase UI taxes immediately as to give UI financing mechanisms a base from which sufficient revenue can be raised when necessary.

States Can Afford to Improve Their UI Programs

According to most employers and their political allies, “now” is never a good time to reform UI programs. During a recession, they say, UI payment levels are too high for reforms to be affordable, and during a recovery there is insufficient need to address UI program shortcomings. In fact, many reforms assisting lower-wage workers can expand UI eligibility without greatly boosting overall trust fund costs, since low-wage workers get modest UI benefit amounts.¹⁴ Widely recommended reforms that have been recently adopted by a number of states include alternative base periods, expanded part-time eligibility, and provisions dealing with good cause forcing individuals to leave due to work/family conflicts.¹⁵ The cost of these reforms individually is modest--roughly 5% of overall benefits--and in the context of downturns would not compare to the significant costs that will arise from increased numbers and durations of claims. In larger states, these recession-related costs will amount to hundreds of millions of dollars annually, while reforms assisting low wage workers or those with family responsibilities will cost some tens of millions. In smaller states, both numbers would be smaller, but the general relationship between costs related to any downturn and costs of reforms remain similar.

Several states with very healthy UI trust funds have serious shortcomings in their UI programs. As a result, these states' UI programs should especially take action to address their shortcomings. As noted earlier, in order to act as an effective UI safety net, state UI programs should pay adequate UI benefits to a significant proportion of jobless workers. During a recession, we have found that added numbers of UI recipients and greater public attention to UI programs makes reforms possible despite the higher benefit costs associated with economic downturns.

Two prime examples of solvent states with seriously deficient UI programs are Louisiana and Mississippi. In Louisiana, just 27 of 100 jobless workers drew UI benefits in 2007, and those lucky enough to qualify received an average weekly UI benefit of only \$204. Mississippi, with a maximum weekly UI benefit of \$210, paid an average weekly benefit of only \$177 to 24 percent of its jobless workers. Both states had lower than average UI payroll tax rates, with Louisiana's 2007 average tax on total payroll coming to only 0.34 percent and Mississippi's at 0.40 percent (compared to a U.S. state average tax rate of 0.69 percent). To a significant degree then, very solvent and very restrictive states such as Mississippi and Louisiana have ridden to solvency on the backs of jobless workers--whose wages are subject to UI payroll taxation--but who have little chance of drawing adequate benefits when they lose work.

Unemployment benefit adequacy is traditionally measured in terms of wage replacement with a rule of thumb being that weekly benefits should replace half of lost earnings up to a maximum weekly benefit of two-thirds of state average weekly wages.¹⁶ Of the 21 states going into 2008 with clearly solvent or adequate trust fund reserves listed above in Table 1, Alaska, Arizona, District of Columbia, Louisiana, Mississippi, and Puerto Rico stand out as jurisdictions with seriously inadequate benefit levels. All 6 rank in the bottom 10 of 53 UI jurisdictions in terms of benefit levels and/or wage replacement ratios (portion of average wages replaced by average state UI benefits). Raising benefits in these "bottom feeder" states would not only assist jobless workers, but businesses in their communities as well.

With unemployment and loss of jobs remaining as central concerns of the public, rebuilding UI safety nets makes sense, especially in those states with above-average solvency. Eligibility reforms addressing needs of low-wage workers have modest costs when compared to their advantages to jobless workers they help. Eight of the 21 most solvent states rank low on UI reciprocity, paying 30 or less of every 100 jobless workers a benefit. Solvent states with restrictive UI reciprocity rates are Arizona, District of Columbia, Florida, Louisiana, Mississippi, New Hampshire, Utah, and Wyoming. And, Mississippi, Nevada, and Utah have restrictive policies limiting eligibility of part time workers for UI benefits. In addition, a number of solvent states do not have alternative base periods (ABPs), a method of counting more recent wages when determining UI eligibility that has been adopted in 20 states. Alaska, Arizona, Florida, Louisiana, Mississippi, Montana, Nebraska, Nevada, Oklahoma, Oregon, Puerto Rico, Utah, the Virgin Islands, and Wyoming are solvent states that have not expanded eligibility for lower wage workers by using ABPs.

By focusing here on policy improvements like higher benefits and expanded UI eligibility in more solvent states, we don't intend to imply that less solvent states shouldn't concern themselves with the fairness and adequacy of their UI safety nets. To the contrary, reforms like part time eligibility and alternative base periods have modest costs and have in past times been adopted as part of an effort to update state UI programs even when trust fund balances were less than ideal. In addition, insolvency can be an occasion for state policy makers to turn their attention to their overall UI program. As states craft policies to chart their way out of insolvency, negotiations typically bring together stakeholders representing workers, businesses and the legislature. In states that have policies that have shortchanged key parts of the workforce, including fixes to these problems remains essential. There have been occasions in recent years when diverse stakeholders have negotiated solvency packages that have included benefit and financing improvements. So, we would say there is never a time when UI reforms should not be considered or when a strong UI safety net is not good policy for a state's workers and employers.

What Happens When States Face UI Insolvency?

Up to now, we have discussed trust fund insolvency as a bad thing, but we haven't said in sufficient detail why states should have adequately financed UI programs.

To begin, it is important to understand that an "insolvent" state does not escape its legal and moral obligations to pay UI benefits to jobless workers. The federal government operates a loan fund from which states can borrow temporary "cash flow" dollars from which they pay UI benefits, or interest-bearing longer-term loans to ensure that state UI benefits are paid. And, a few states have experimented with issuing bonds or borrowing from state-level sources to avoid federal loans. So, it is important to understand that regardless of whether or not a state's UI trust fund is properly funded, UI benefits will be paid. And, if a state doesn't act at a state-level within 2 years of incurring federal indebtedness by using state revenues to repay federal loans, federal law automatically reduces the tax credit of 90 percent ordinarily provided to a state's employers against the federal excise tax on wages, called the Federal Unemployment Tax Act (FUTA) tax. As a result, the recurring 0.8 percent of taxable wages (first \$7000 paid in a calendar year) FUTA tax of \$56 is increased in small annual increments. The resulting increased federal payroll taxes are applied towards reducing the insolvent state's federal loan balance for as many years are required for that state to return to solvency.¹⁷ States are still required to raise any federal interest due on loans from state sources.

Surprisingly, it is not as true as you might think that better financed state UI programs pay more generous benefits and have higher UI reciprocity rates. And, although we think generous benefits and expanded eligibility is what employers fear when they oppose indexing taxable wage bases and other measures that

increase UI solvency, there are several very solvent states that basically got to that financial status by operating very restrictive state UI programs. As a result of the mixed record of states, generalizations about how UI financing impacts UI program are difficult to reach. Indeed, in recent years, California has rectified years of shamefully low benefits by raising its maximum weekly benefit from only \$230 a week in 2001 to \$450 a week by 2005, but it has yet to increase its taxable wage base to keep up with the rapid growth in wages and cost of living in the state. Meanwhile, Minnesota and Pennsylvania are among the ranks of better state UI programs for jobless workers, while they rely upon "pay as you go" financing (MN, PA).

Despite the fact that there are states with poorly managed trust funds that have decent UI programs, we believe that there are important advantages to maintaining a properly financed state UI program that policymakers should consider. In summary, properly financed state UI programs build reserves during economic recovery periods and draw upon those reserves to pay UI benefits and avoid immediate payroll tax increases during economic downturns. Adequately financed UI programs collect federal interest on trust fund balances which can amount to hundreds of millions of dollars for larger states. Underfinanced states face pressures to raise taxes and cut benefits during downturns. Less solvent states give up potential federal interest on their trust funds and must use state revenues to pay the lion's share of UI benefits.

The Advisory Council on Unemployment Compensation, a bipartisan, federal panel convened in the early 90s, recommended that states "should accumulate adequate [trust] funds during periods of economic health in order to promote economic stability by maintaining consumer purchasing power during economic downturns"¹⁸ As we have explained, this ACUC recommendation is consistent with the design of UI programs and the practice of the majority of states. NELP supports policies that maintain forward funding as important to ensuring that UI programs perform their vital safety net functions during recessions without requiring employers to bear higher UI taxes or sacrificing benefit levels or eligibility.

State Policies that Promote Forward Funding and UI Trust Fund Solvency

A number of policies are significant to maintaining or restoring UI trust fund solvency and achieving forward funding goals. We feature three basic measures here.

1. UI payroll taxes are imposed only upon a portion of wages, called the "taxable wage base." The minimum taxable wage base permitted by federal law is \$7000. Indexing taxable wage bases to reflect growth in wages is highly related to having an adequate financial base for UI programs. Sixteen states have indexed taxable wage bases. Having a higher taxable wage base is important because the ability of a state's UI trust fund to recover more quickly from the impact of a recession is limited if only a small proportion of wages is subject to taxation. For that reason, we recommend that states have higher taxable wage bases and that they index their taxable wage bases. This is the single most important measure that states can take to move toward greater solvency and forward financing.
2. The range of taxes set by state law is another important factor in UI financing. The maximum tax rate controls the ability of a state's UI tax schedule to recover from recessions and impacts on its experience rating as well. States that set their maximum tax rates too low will see greater numbers of "high cost" employers that don't repay trust fund withdrawals made for UI benefit payments to their laid off employees. Federal law permits a maximum rate of no lower than 5.4 percent. States with low taxable wage bases and low maximum tax rates will face UI solvency problems in many cases because their financing mechanisms cannot keep pace with increased benefit payments following a downturn.

3. Many states have adopted zero or near zero minimum tax rates. Zero tax rates are ordinarily applied to employers that have no UI claims filed by former employees for a number of years. These “good” employers, however, then obtain insurance on their employees' wage loss without having to pay any premium (i.e., UI payroll taxes). Since all employers benefit from having UI programs in place to protect not only their employees from the risk of wage loss, but to boost a state's economy when employees of other firms are laid off, a zero minimum tax rate is not good UI financing policy. All covered employers should contribute something toward UI programs, since all employers take some benefit from the positive economic and social impacts of social insurance.

We believe that jobless workers and a state's employers benefit over time from having an adequately financed UI program with trust fund reserves accumulated prior to economic downturns. In order to have forward funding and UI trust fund solvency, states must attend to financing their UI trust funds in both good times and in bad times. Policymakers and advocates focusing on UI solvency should reexamine their state's UI financing provisions in order to ensure that UI trust funds are both solvent and forward funded.

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Table 2: State Trust Fund Solvency Indicators–2000 and 2007

State	Fund Balance 12/31/07 (millions)	Reserve Ratio 4th Qtr 2007	AHCM 4th Qtr 2007	Reserve Ratio 4th Qtr 2000	AHCM 4th Qtr 2000	Taxable Wage Base-2008
Alabama	\$410.6	0.72	0.52	0.97	0.65	\$8000
Alaska	\$331.2	3.36	1.07	3.23	1.03	\$31,300
Arizona	\$990.5	1.10	1.10	1.68	1.68	\$7000
Arkansas	\$151.1	0.49	0.32	1.12	0.68	\$10,000
California	\$2533.1	0.40	0.27	1.16	0.78	\$7000
Colorado	\$630.4	0.74	0.67	1.15	1.05	\$10,000
Connecticut	\$598.1	0.76	0.54	1.35	0.96	\$15,000
Delaware	\$174.2	1.10	0.91	2.69	2.02	\$10,500
Dist. of Columbia	\$400.3	1.47	1.11	1.40	1.05	\$9000
Florida	\$2203.9	0.85	1.04	1.15	1.40	\$7000
Georgia	\$1281.8	0.90	0.96	1.73	1.79	\$8500
Hawaii	\$556.3	3.17	1.88	2.63	1.56	\$13,000
Idaho	\$196.0	1.10	0.46	2.25	0.95	\$32,200
Illinois	\$1802.0	0.79	0.34	1.13	0.48	\$12,000
Indiana	\$306.8	0.35	0.29	2.14	1.57	\$7000
Iowa	\$740.2	1.81	0.89	2.61	1.24	\$22,800
Kansas	\$638.0	1.40	0.96	1.43	0.93	\$8000
Kentucky	\$230.8	0.45	0.21	1.73	0.77	\$8000
Louisiana	\$1444.8	2.54	0.93	3.71	1.36	\$7000
Maine	\$479.2	3.19	1.64	2.77	1.43	\$12,000
Maryland	\$1016.7	1.14	0.78	1.37	0.94	\$8500
Massachusetts	\$1290.3	0.90	0.50	1.76	1.01	\$14,000
Michigan	\$31.1	0.02	0.0	2.21	0.75	\$9,000
Minnesota	\$545.6	0.59	0.38	0.97	0.58	\$25,000
Mississippi	\$727.9	2.60	1.70	3.11	1.98	\$7000
Missouri	\$113.2	0.14	0.12	0.72	0.55	\$12000
Montana	\$280.5	2.47	1.45	2.42	1.42	\$23,800
Nebraska	\$278.9	1.16	1.21	0.95	0.99	\$9000
Nevada	\$793.2	1.73	1.02	1.81	1.07	\$24,600
New Hampshire	\$240.4	1.08	1.16	1.89	2.01	\$8000
New Jersey	\$650.4	0.38	0.21	2.20	1.15	\$27,700
New Mexico	\$575.5	2.59	1.85	3.91	2.79	\$19,900
New York	\$429.7	0.11	0.09	0.41	0.31	\$8500
North Carolina	\$394.4	0.31	0.23	1.20	0.91	\$18,600
North Dakota	\$134.4	1.68	0.80	0.60	0.28	\$22,100
Ohio	\$444.5	0.27	0.12	1.55	0.64	\$9000
Oklahoma	\$831.4	1.94	1.54	1.84	1.46	\$13,600
Oregon	\$1933.2	3.67	1.46	3.74	1.48	\$30,200
Pennsylvania	\$1545.7	0.83	0.30	1.94	0.68	\$8000
Puerto Rico	\$529.3	3.22	1.00	4.00	1.24	\$7000
Rhode Island	\$159.9	1.08	0.37	2.61	0.89	\$14,000
South Carolina	\$199.2	0.38	0.26	1.90	1.29	\$7000
South Dakota	\$24.7	0.27	0.33	0.76	0.84	\$9000
Tennessee	\$566.2	0.65	0.48	1.13	0.90	\$7000
Texas	\$1774.7	0.46	0.44	0.27	0.26	\$9000
Utah	\$842.7	2.32	1.44	2.60	1.61	\$25,400
Vermont	\$177.6	2.28	1.21	4.81	2.54	\$8000
Virgin Islands	\$22.3	1.96	0.78	8.08	3.33	\$21,800
Virginia	\$775.2	0.58	0.70	1.11	1.32	\$8000
Washington	\$3,794.2	3.76	1.54	2.46	1.04	\$31,400
West Virginia	\$244.8	1.40	0.45	1.65	0.52	\$8000
Wisconsin	\$592.2	0.72	0.29	2.75	1.08	\$10,500
Wyoming	\$243.5	2.89	1.13	4.10	1.61	\$20,100
United States	\$38,302.7	0.80	0.52	1.46	0.91	\$11,482

Prepared by the National Employment Law Project based upon information from U.S. Department of Labor, Office of Workforce Security, Department of Actuarial and Fiscal Services, [UI Data Summary](#) for 4th calendar quarter for 2007 and 2000. Fourth quarter reserve ratios based upon extrapolated wages. Taxable wage bases from USDOL [Significant Provisions of State UI Laws](#) (January 2008).

Endnotes

¹ For added background, see Wayne Vroman, "The Recession of 2001 and Unemployment Insurance Financing," (Urban Institute, January 2005), available on the Urban Institute website. For more in-depth information, see Wayne Vroman, *Topics in Unemployment Insurance Financing* (Kalamazoo, Michigan, Upjohn Institute, 1998) and Marc Baldwin, *Beyond Boom and Bust: Financing Unemployment Insurance in a Changing Economy* (National Employment Law Project, April 2001). All NELP documents cited are available at our website <www.nelp.org>. Portions of this briefing paper appeared in earlier NELP publications on UI financing and solvency.

² The Average High Cost Multiple compares a single year of high payouts to single year of high benefits. As benefit levels in today's economy appear to be elevated over a several year period, we believe it is wise for states to look at the reserve ratio as well as the AHCM. In using both AHCMs and reserve ratios, NELP goes beyond more cautious official solvency standards relying solely upon cost multiples.

³ Advisory Council on Unemployment Compensation, *Unemployment Insurance in the United States: Benefits, Financing, Coverage* (U.S. Department of Labor, Washington, D.C., 1995), p. 9. See also U.S. Department of Labor, Employment and Training Administration, "Reserve Adequacy," Unemployment Insurance Program Letter No. 44-81 (October 13, 1981).

⁴ For purposes of UI programs, U.S. Department of Labor publishes data on 53 jurisdictions--namely, the 50 states and District of Columbia, Puerto Rico, and Virgin Islands. We use "states" from time to time in this paper to indicate all 53 UI jurisdictions. And, for this reason, our state counts add to 53, rather than 50.

⁵ Wayne Vroman, *Topics in Unemployment Insurance Financing*, p. 10.

⁶ Details about states shifting away from forward financing toward pay as you go financing can be found in Vroman, "The Recession of 2001; Baldwin's *Beyond Boom and Bust*, cited above, pp. 21-23; and Statement of Maurice Emsellem, House Ways and Means Committee, Subcommittee on Human Resources (March 9, 2000).

⁷ Vroman, "The Recession of 2001," at p. 12.

⁸ The figures regarding trust fund balances and solvency measures in Table 2 and Figure 1 are found in the U.S. Department of Labor, Office of Workforce Security, Division of Actuarial Services, "UI Data Summary," for calendar quarters. Revenue and benefit payments figures are found in "UI Outlook, FY 2008 Budget-Mid-Session Review" (July 2007) and "UI Outlook, FY 2009 President's Budget" (February 2008). All these sources are available online at the Department of Labor's Office of Workforce Security website at <<http://ows.doleta.gov/unemploy>>.

⁹ Vroman, "The Recession of 2001," Table 1 and Table 2.

¹⁰ Maurice Emsellem, "Status of 2002 Reed Act Distribution by State as of January 2003," (National Employment Law Project: March 24, 2003).

¹¹ Rick McHugh and Andrew Stettner, Briefing Paper, "Indexed State Taxable Wage Bases: Taking a Significant Step Toward Better UI Financing," (National Employment Law Project, February 2004).

¹² Phillip B. Levine, "Financing Benefit Payments," in Christopher J. O'Leary and Stephen A. Wandner, ed., *Unemployment Insurance in the United States: Analysis of Policy Issues*, (Kalamazoo, Michigan, Upjohn Institute, 1997), p. 332.

¹³ Vroman, *Topics in Unemployment Insurance Financing*, p. 19; Advisory Council on Unemployment Compensation, *Unemployment Insurance in the United States: Benefits, Financing, Coverage* (U.S. Department of Labor, Washington, D.C., 1996), p. 71-72.

¹⁴ NELP furnishes technical assistance with cost estimates for proposed UI reforms. See Rick McHugh and Andrew Stettner, Briefing Paper, "How Much Does Unemployment Insurance for Jobless Part Time Workers Cost?" (May 2005). For cost estimates on ABPs, see Wayne Vroman, *Alternative Base Periods: Final Report*, UI Occasional Paper 95-03 (U.S. Department of Labor, January 1995), available under "Advisories" on the OWS website.

¹⁵ For more information regarding these UI reform issues, readers can consult *Changing Workforce/Changing Economy* (National Employment Law Project, 2005), available and updated on NELP's website.

¹⁶ Advisory Council, *Unemployment Insurance in the United States: Benefits, Financing, Coverage*, p. 20.

¹⁷ For more detailed accounts of federal loans to state trust funds and how the FUTA tax credit reduction mechanism works, see Wayne Vroman's pieces cited above in note 1.

¹⁸ Advisory Council, *Unemployment Insurance in the United States: Benefits, Financing, Coverage*, p. 8.