

# Solvency of Unemployment Insurance: Effectiveness as an Automatic Stabilizer

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# Key Points

- In the aggregate, state unemployment insurance (UI) programs provide powerful automatic stabilization for the economy.
- A movement away from forward funding toward pay-as-you-go funding could lessen the UI system's automatic stabilization effects.
- Imagining a tax rate equal to the benefit cost rate in the previous year shows how in the extreme the UI system would be less stabilizing if the system moved away from forward funding and toward pay-as-you-go funding.

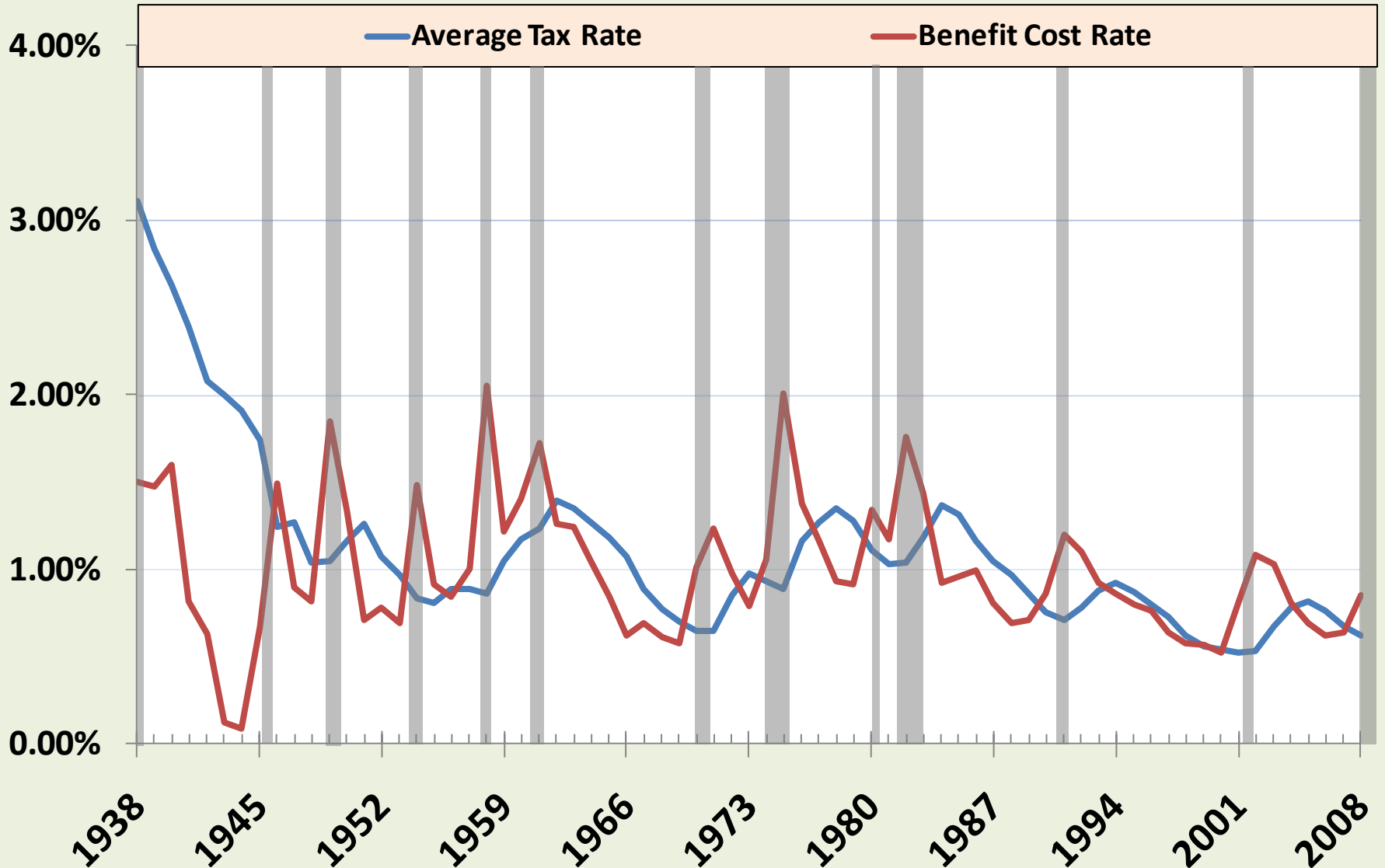
# Automatic Stabilization

- The graph on the next slide shows how Unemployment Insurance serves as an automatic economic stabilizer.
- The “benefit cost rate” is in red. It is the percent obtained from the ratio of state benefits paid to claimants and wages paid in state covered employment in each year.
- The “average tax rate” is in blue. It is the percent obtained from the ratio of state unemployment taxes paid by employers to wages paid in state covered employment in each year.
- The shaded vertical bars mark the years in which there were recessions.

# Automatic Stabilization (Continued)

- The benefit cost rate exceeds the average tax rate substantially during recessions and the opposite is true during periods of economic growth.
- For example, at the end of the two-year recession in 1975 the benefit cost rate at 2 percent was over twice the tax rate.
- When the data are available for 2009, similar stimulus likely will be shown during the “Great Recession”
- For fiscal year 2010, the state programs are estimated by the U.S. Department of Labor to provide about \$45 billion in automatic stimulus (state unemployment benefits paid minus state unemployment taxes collected) to the economy.

# ECONOMIC RECESSIONS (YEARS SHADED): 1938 - 2008



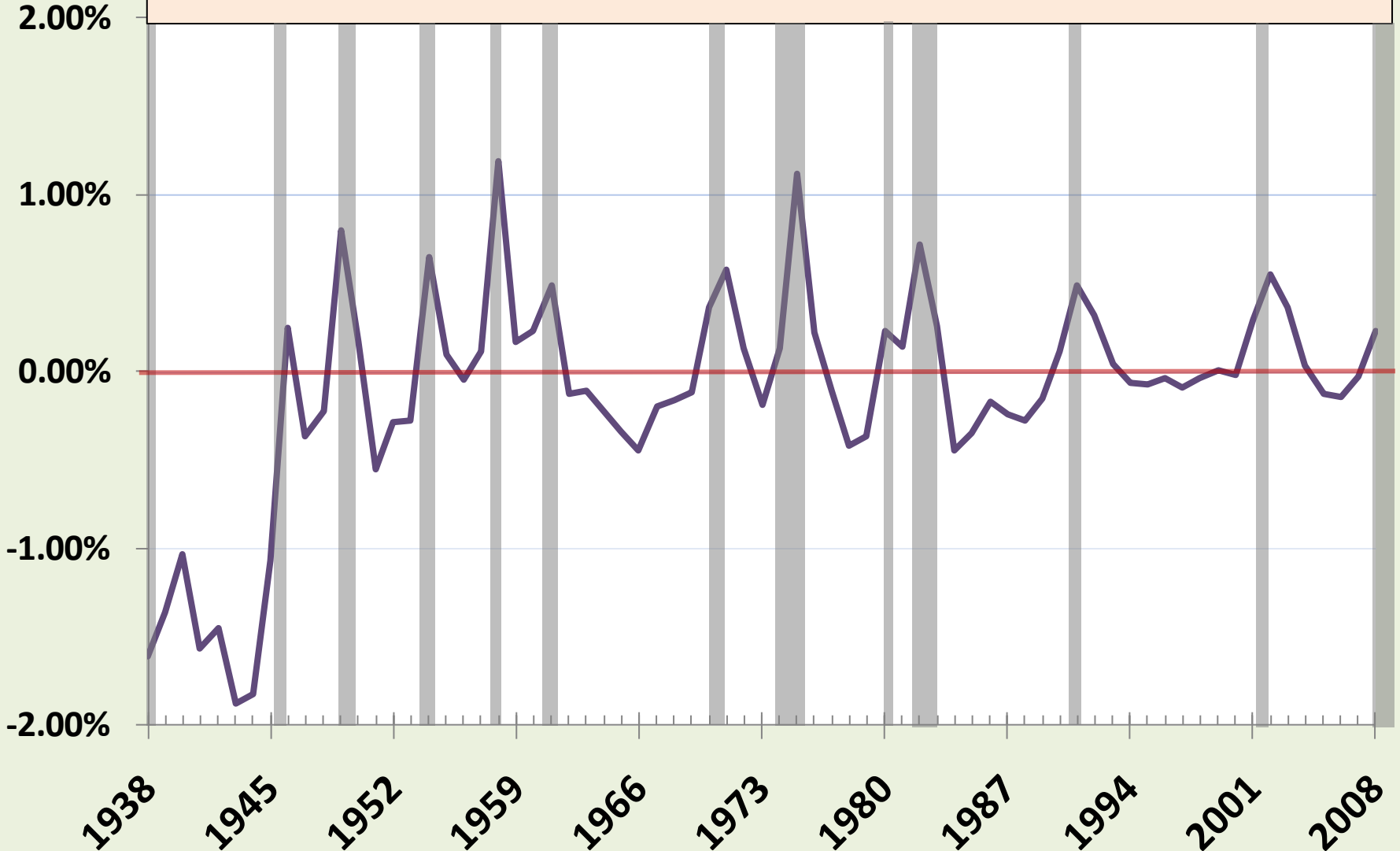
Source: USDOL, ETA; National Bureau of Economic Research

# Automatic Stabilization (continued)

- The next slide shows a graph of the difference between the benefit-cost rate and the average tax rate. When this time series is above zero the UI system stimulates the economy and when it is below zero it restrains the economy.
- One can see clearly the difference between the benefit cost rate and the tax rate is positive during recessions, noted by the shaded vertical bars, and negative during periods of economic growth after recessions.

# ECONOMIC RECESSIONS (YEARS SHADED): 1938 - 2008

— Difference Between Benefit Cost Rate and Average Tax Rate



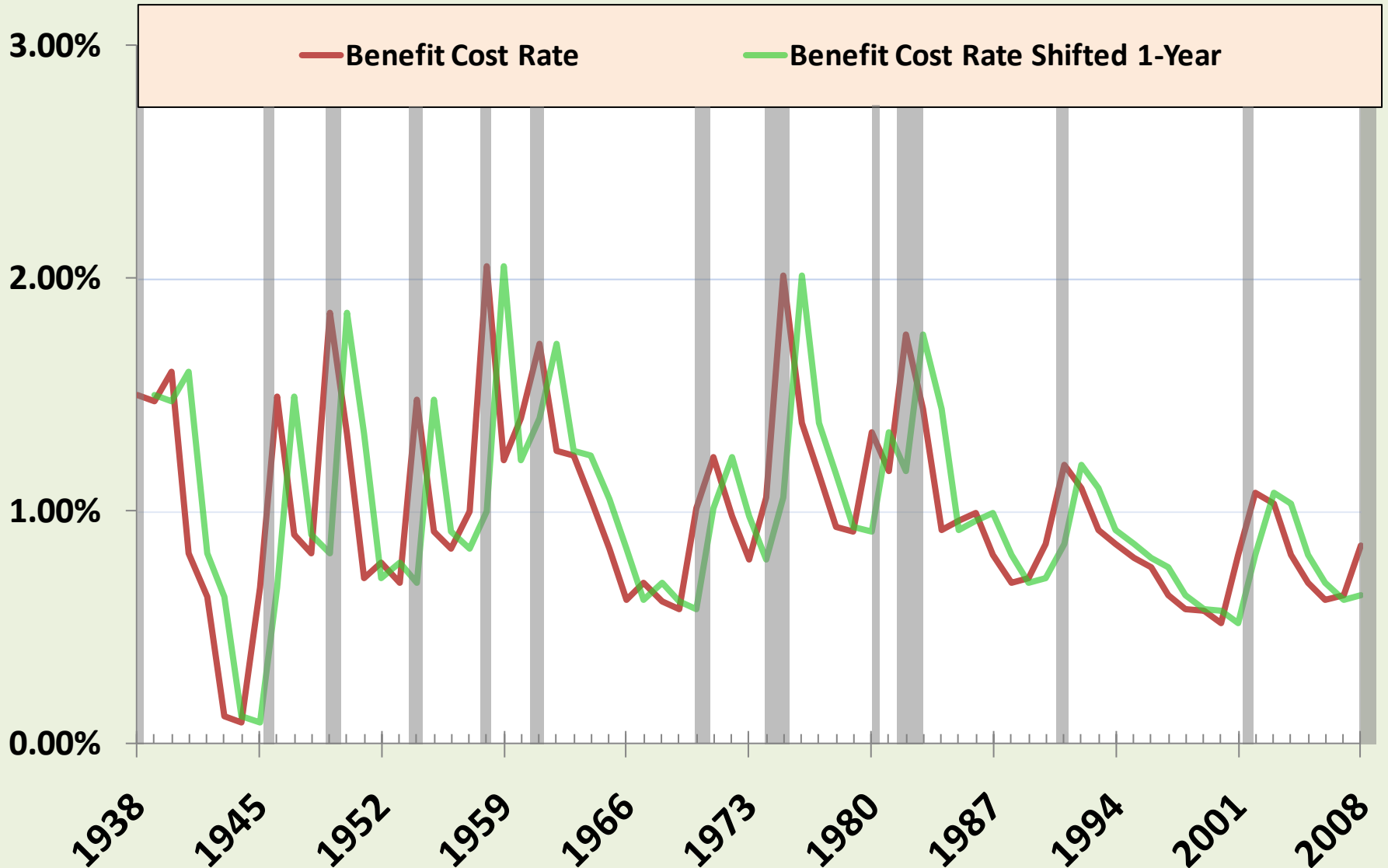
Source: USDOL, ETA; National Bureau of Economic Research

# What If States Moved Away from Forward Funding?

- Some states have consciously built up relatively low reserves in good times with the expectation of borrowing in bad times to cover benefits and then raising taxes to repay loans and replenish reserves.
- What if states took this approach to an extreme and imposed a tax rate equal to the benefit cost rate in the prior year?
- Would such an approach be less stabilizing?
- The next slide shows the actual benefit cost rate and an imagined tax rate equal to the benefit cost rate shifted forward one year.



# ECONOMIC RECESSIONS (YEARS SHADED): 1938 - 2008



Source: USDOL, ETA; National Bureau of Economic Research

# Average Tax Rate Compared to Hypothetical Tax Rate

- The next slide compares the actual average tax rate to the hypothetical tax rate (benefit cost rate shifted forward one year) that might occur if all states moved away from forward funding and toward pay-as-you-go funding.
- The hypothetical tax rate increases much more immediately after a recession and remains higher for two or three years, which would reduce the stabilizing effects of the system.
- Such an outcome reduces the system's effectiveness at achieving one of its primary goals, to stabilize the economy.

# Actual Average Tax Rate Compared to Hypothetical Tax Rate

