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## **Unemployment Insurance**

# Unemployment Insurance

## Introduction

Unemployment insurance (UI) is a shared federal-state system that provides partial wage replacement to workers who lose their jobs through no fault of their own and who are able to work, available to work, and actively seeking work. It also connects workers with reemployment services.

Virtually all workers face the risk of becoming laid off at some point during their careers. In 2014, 10.9 percent of those who worked or looked for work were unemployed at some point during the year.<sup>1</sup> When unemployment occurs, most workers find it difficult to make ends meet. Unemployment insurance is intended to help these workers stay afloat during the search for new employment.

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The number of workers meeting eligibility requirements and receiving UI benefits varies depending on how the economy is doing, as well as due to state differences in eligibility rules, benefit levels, and benefit durations. In 2015, when the unemployment rate was roughly half of what it was early in the economic recovery in 2010, 6.6 million workers applied for and received benefits. In comparison, 14.4 million workers applied for and received benefits in 2009 and joined millions more already receiving benefits. Between 2008 and 2013, which included the years of the Great Recession, 24 million workers received extended and emergency benefits.<sup>2</sup> The total system cost of UI benefits varies with changes in the number of recipients. In 2015, total benefits paid from the regular UI program were \$32.5 billion. In 2010, this figure, including all state and federal benefits, was five times as large at \$156 billion.<sup>3</sup> These differences are partially the result of increased numbers of unemployed people and in part the result of temporary changes in the UI system during the recession.

The following sections of this *Report* describe and take stock of the UI system's benefits, administration, financing, and reemployment services. Within each section, a set of current policy challenges and reform options is presented.

<sup>1</sup> U.S. Department of Labor, 2015, "Work Experience Summary," Bureau of Labor Statistics, December 9, 2015, <http://www.bls.gov/news.release/work.nr0.htm>.

<sup>2</sup> These benefits are described in the following section. Council of Economic Advisers and the Department of Labor, 2013, "The Economic Benefits of Extending Unemployment Insurance," <https://www.whitehouse.gov/sites/default/files/docs/uiereport-2013-12-4.pdf>.

<sup>3</sup> U.S. Department of Labor, 2016, "Unemployment Insurance Outlook: FY 2017 Midsession Review," Division of Fiscal and Actuarial Services, Office of Unemployment Insurance.

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## **Unemployment Insurance Financing**

## Unemployment Insurance Financing

### Background

Unemployment insurance is funded by a federal tax paid by employers under the Federal Unemployment Tax Act (FUTA) and by employers' state contributions. The federal taxable wage base for UI has been in place since nearly the beginning of the UI program.<sup>13</sup> It is currently \$7,000. This taxable wage base effectively serves as a floor below which states cannot lower their wage base. States must at least meet the minimum taxable wage base to maintain a UI system in compliance with federal law, under which employers may receive an offset credit to the federal unemployment tax. To maintain a qualifying program, states are also required to base employers' contribution rates on factors related to employers' experience with layoffs, known as "experience rating."

All state UI contributions (taxes) are required by federal law to be deposited into state accounts in the Unemployment Trust Fund (UTF) held by the U.S. Treasury Department. Employers pay UI contributions to state agencies that, in turn, transfer these contributions into the state unemployment benefit accounts maintained by the Treasury on behalf of the states. Employer tax rates vary with their payroll, experience rating, and contribution payments.

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UI was designed to serve as an automatic stabilizer in the U.S. economy during periods of recession. To operate as originally intended, there must be "forward funding" – that is, states must collect enough taxes in good economic times to pay benefits during recessions without having to borrow. The advantage of this approach is to

reduce the need for states to more heavily tax employers during economic downturns and nascent recoveries to pay benefits, precisely when fiscal stimulus in the form of lower taxes may be more effective. In cases of severe downturns, the federal loan account in the UTF lends money to states whose UI accounts contain insufficient reserves to pay benefits. Ideally, a state's UI trust fund should have adequate reserves to provide benefits during a future recession without the need to raise taxes, reduce benefits, or borrow to pay unemployment compensation.

<sup>13</sup> Upon the passage of the UI program as part of the Social Security Act in 1935, all wages were subject to UI taxes. The taxable wage base of \$3,000 was established in 1939.

## Policy Challenges

### *Imbalance between revenues and costs*

The UI system was established with the expectation that states would impose a state tax on wages paid by employers that is adequate to pay benefits. The federal taxable wage base has remained at \$7,000 since 1983. Three states set their taxable wage base at this level.

### *Insufficient forward funding*

Most states are failing to adequately forward-fund their UI trust funds. Six years into the recovery from the Great Recession, two-thirds of state UI programs were still below DOL's minimum recommended trust fund ratio.<sup>14</sup> As of January 2016, three states had failed to pay

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off their outstanding federal loans, and six additional states had outstanding private loans. Forward funding is essential to achieving the system's countercyclical function and to ensuring its long-term reliability in helping laid-off workers. By failing to build adequate reserves for the next recession, these states will have to borrow funds or rely instead on federal lawmakers to use general federal revenues or federal reserves (which also are typically insufficient) to pay EUC benefits. Weak federal incentives for adequate state financing along with frequent and plentiful federal EUC programs may exacerbate state underfunding.

The federal government could take steps to avoid the necessity of doing what it did in the Great Recession: 1) lending substantial amounts to state UI trust fund accounts for payment of benefits under the regular program, and 2) fully paying for both the permanent Extended Benefits program and any additional temporary emergency benefit programs at considerable cost to the federal budget.

<sup>14</sup> Specifically, 35 states out of 53 have trust fund solvency levels below an average high cost multiple of 1.0. U.S. Department of Labor, 2016, "State Unemployment Insurance Trust Fund Solvency Report," <https://www.oui.doleta.gov/unemploy/docs/trustFundSolvReport2016.pdf>.

## Policy Options

### Address the Imbalance between Revenue and Costs

#### *Increase the FUTA tax base*

Increasing the FUTA tax base could provide more funds for federal appropriators to allocate to state administration. It could also encourage states with inadequate trust fund reserves and tax bases that are close to the level of the federal wage base to better fund their reserves through higher UI contributions.

#### *Enhance guidelines for experience rating of employer contribution rates*

State UI tax rates paid by employers increase with the employers' past level of UI benefit payments or a measure of the employers' reserves in their UI accounts. This "experience rating" system is meant to encourage employers to minimize the number of layoffs they conduct. Some states have tax rates as low as zero for employers that have favorable experience ratings, and have rates that exceed 5.4 percent for employers with unfavorable experience ratings. Some states have as few as two tax rates for employers, though most have many more rates that more closely track an employer's experience with layoffs. The experience rating system could be left as it is, although it does not adequately reflect layoff "experience" in some states. Alternatively, a federal guideline could be established providing a state experience rating goal to be used in periodic federal performance evaluations.

#### *Create guidelines to encourage states to evaluate the impact of minimum tax rates and maximum tax rates*

Currently there is no requirement that employers pay a minimum state UI tax, except that new employer contribution rates must be at least 1.0 percent. Some states allow a zero tax on the employers who have the best UI experience rating. A zero tax means that the risk of benefit payment to workers from those the employers is very low, but exposes the fund to some risk if those businesses have layoffs or close. Conversely, maximum tax rates mean that some employers with extensive experience with layoffs are not fully charged for those layoffs. A guideline to be used in evaluating performance could be developed as a basis for zero or minimum tax rates and maximum tax rates.

#### *Implement employee taxes*

Workers have a direct stake in being able to access unemployment insurance benefits when they become involuntarily unemployed, but only three states levy a UI tax on employees. A nationwide employee UI tax could be a method of restoring the trust fund solvency in the near future of the UI system and providing new funds for long-term benefit adequacy. It could also reduce

or eliminate the UI tax burden for employers. Employee taxes have been used successfully by UI programs in other industrial nations ensure adequate funding.

### *Enact "Reed-Act"-type distributions to state unemployment trust funds*

Regular Reed Act distributions occur when the federal accounts in the UTF reach certain statutory levels. At that time, excess funds are distributed to state accounts in the UTF, prorated to each state's share of covered wages. Special Reed Act distributions can occur from federal accounts to state accounts by congressional action, regardless of whether there are excess funds in the federal accounts as defined by existing statute. Reed Act distributions can only be spent by states to provide UI benefits, administer UI, or provide employment services. Greater use of Reed Act distributions from the federal to state accounts could serve to improve the adequacy of funding for UI programs.

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### **Incentivize Forward Funding**

To incentivize forward funding, the U.S. Treasury could pay higher interest rates on the state funds held by the federal government to states with more adequate trust fund reserves, and lower rates to states with poorer trust fund reserves.<sup>15</sup> This way, states may face greater economic incentives when considering the trade-offs in building UI reserves in time for the next recession, as opposed to relying on borrowing after a downturn to finance their systems.

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<sup>15</sup> Adequacy of reserves is measured by a state's high-cost multiple (HCM), which represents a state's reserve ratio (its UI trust fund level as a percentage of total annual statewide wages) divided by the high cost rate (the highest historical ratio of benefits to wages for a 12-month period in that state). An HCM of 1.0 corresponds to sufficient reserves to pay benefits at the high cost rate for 1 year without relying on payroll tax revenue.