

Unemployment Insurance Trust Fund Solvency and the Great Recession: Lessons and Opportunities for Reform

**New England Fiscal Leaders Meeting
February 25, 2012**

**Jennifer Weiner, Senior Policy Analyst
New England Public Policy Center
Federal Reserve Bank of Boston**

Material in this presentation is subject to further review and revision.
Views expressed are the author's and are not necessarily those of the
Federal Reserve Bank of Boston or the Federal Reserve System.



Overview

- Background on UI program
- Borrowing in the Great Recession
- Data comparisons
- Lessons from New England
- Conclusions and recommendations

Unemployment insurance (UI): The basics

- Federal-state program established by the Social Security Act of 1935
- Primary objectives:
 - Provide temporary, partial compensation for lost earnings of individuals who become unemployed through no fault of their own
 - Stabilize the economy during economic downturns
- 53 separate programs (50 states + DC, PR, and VI)

Unemployment insurance (UI): The basics

- States operate programs within federal guidelines, but have flexibility
- Some common themes:
 - Eligible recipients must be attached to the labor force and have lost their job through no fault of their own
 - Benefit amounts tied to previous earnings, and typically available for up to 26 weeks
 - Financed by employer taxes

UI financing: The basics

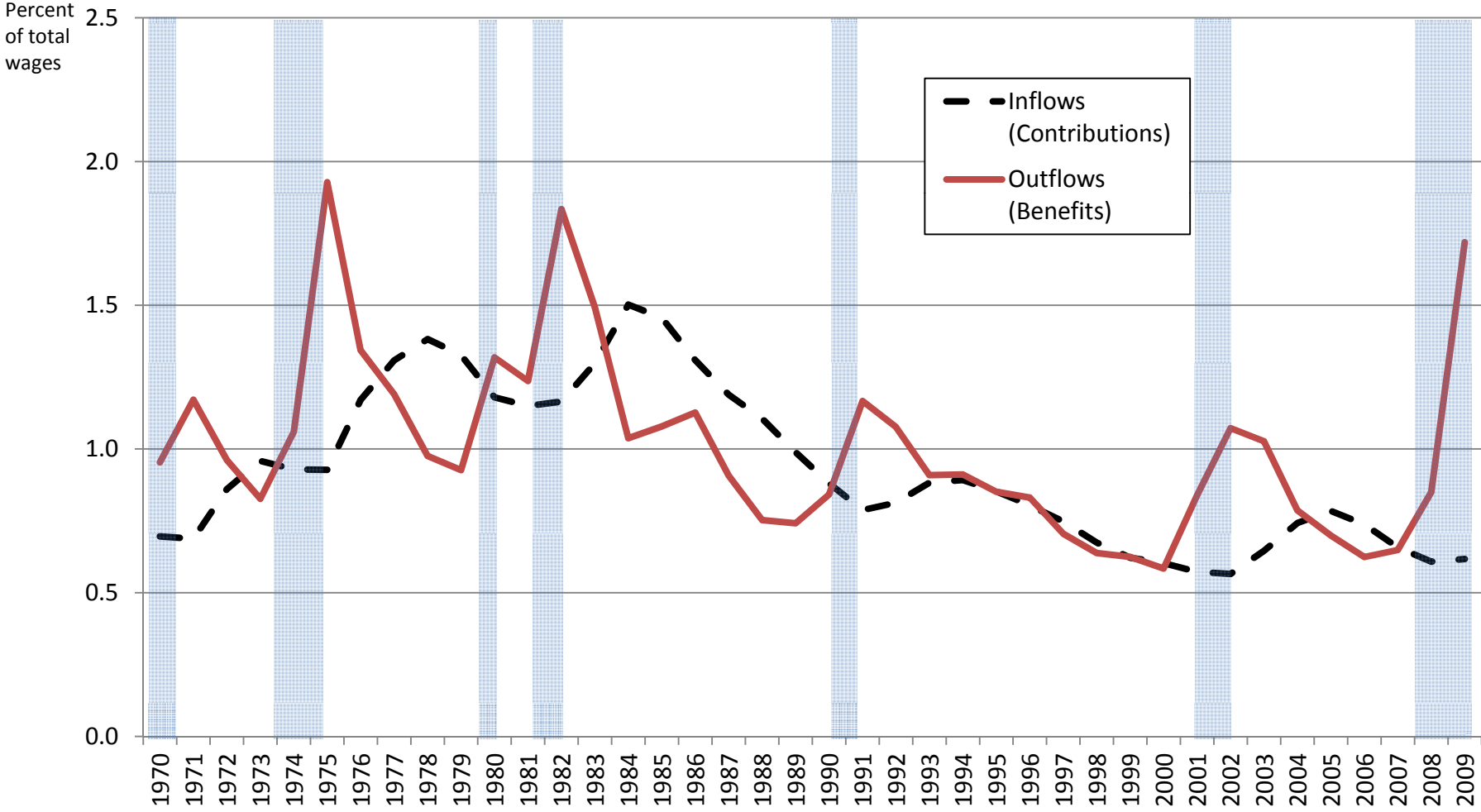
- Employers pay a tax per employee based on:
 - The state's taxable wage base
 - The employer's tax rate which depends on:
 - Experience rating
 - Overall financial health of the program
- Employers also pay a separate UI tax to the federal government (the FUTA)

UI accounting: The basics

- UI programs operate outside of state general funds
- The federal government maintains a trust fund account for each state UI program:
 - Employer tax payments flow into the trust fund
 - Benefit payments flow out of the trust fund
 - Cumulative difference between trust fund inflows (plus interest earned) and outflows = reserves

UI trust fund flows relative to total wages, average of all state UI programs, 1970-2009

UI trust fund flows relative to total wages, average of all state UI programs, 1970-2009



Source and note: U.S. Department of Labor, Employment & Training Administration. Shading approximates recessions.

Borrowing from the federal government

- If a state's trust fund reserves are not sufficient to pay benefits, it can borrow from the federal government
- “Typical” borrowing rules:
 - Interest-free short term borrowing if certain criteria are met (“cash-flow” loans)
 - Prolonged borrowing can carry interest charges and higher effective FUTA tax rates for employers

Borrowing from the federal government

- Money in trust fund **cannot** be used to pay interest on federal loans
- Options for interest payments include:
 - Special tax or assessment on employers
 - General fund appropriations (or other fund transfers)
 - Proceeds from a bond issue

UI borrowing in the Great Recession

- 35 states had an outstanding loan balance in at least one quarter between 2007:Q4 and 2011:Q2
- 28 states still have outstanding loans
- Interest charges waived in 2009 and 2010; first interest payments due in September 2011 and totaled over \$1B
- Most states covering interest charges with employer taxes

Focus on borrowing in New England states

State	First quarter borrowing	Total quarters borrowing 2007:Q4-2011:Q2	Peak loan balance as % of total quarterly wages 2007:Q4-2011:Q2	Outstanding loan balance as of mid-year 2011	Plan for interest repayment	FUTA credit reduction
CT	2009:Q4	7	3.17	\$809 million	Employer	2011
ME	NA	0	0.00	\$0	NA	NA
MA	2010:Q1	4	0.90	\$0	NA	NA
NH	2010:Q1	2	0.36	\$0	NA	NA
RI	2009:Q1	10	5.54	\$226 million	Employer	2011
VT	2010:Q1	6	2.56	\$78 million	General fund	2012

Why should we care about UI trust fund solvency?

- Insolvency can negatively impact the stabilizing effects of the program and potentially slow economic recovery (which can have other fiscal impacts)
 - States may be pressured to raise taxes or reduce benefits, taking money out of the economy
 - States may face interest charges and higher FUTA taxes which can also slow recovery

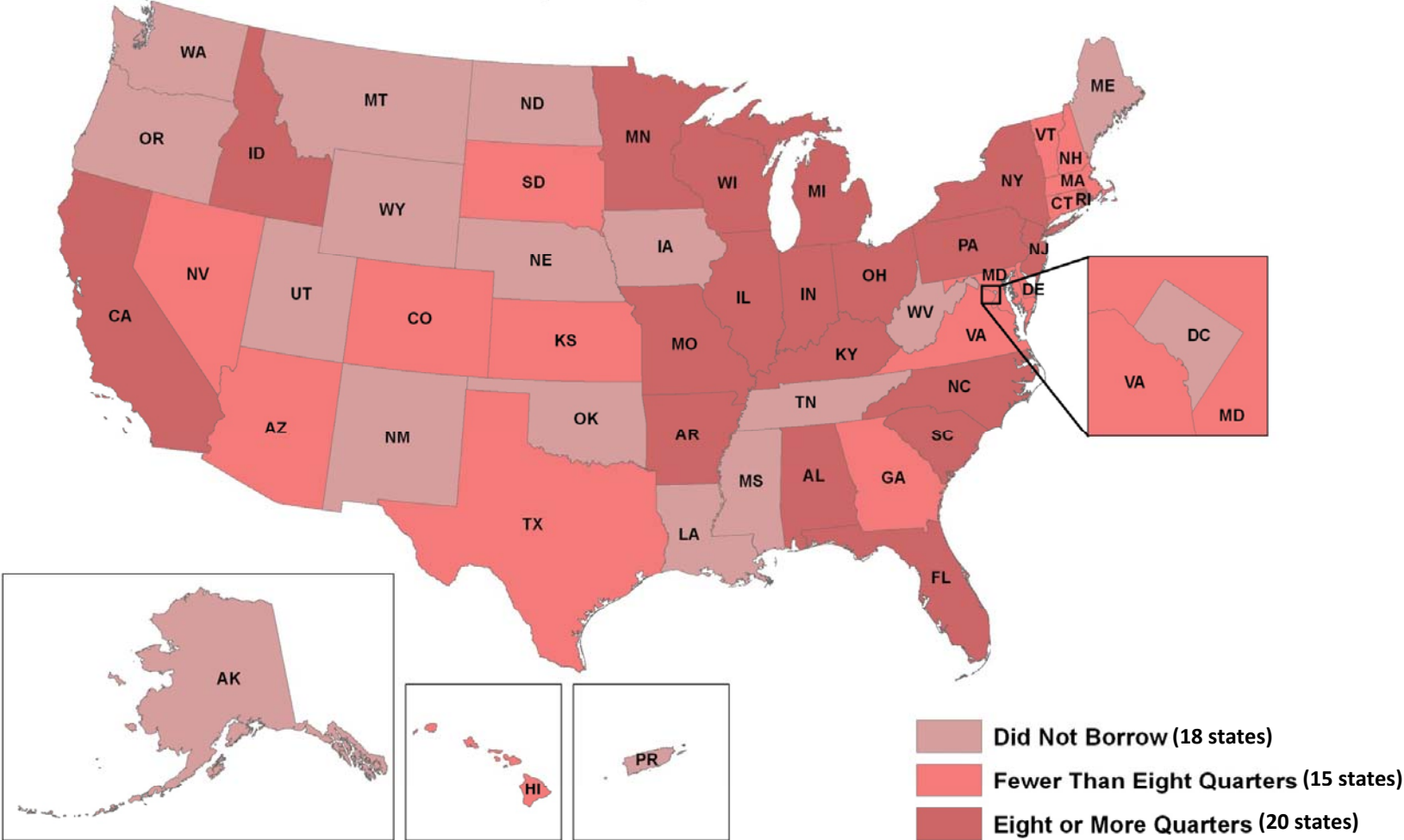
Questions explored in this research

- Why did some state UI programs become insolvent during or after the Great Recession, while others did not?
- What trends or reforms contributed to the insolvency (or solvency) of the New England UI programs?

Approach

- Classify states into three groups:
 - Non-borrowers
 - “Light” borrowers (loans in fewer than 8 quarters)
 - “Heavy” borrowers (loans in 8 or more quarters)
- Compare groups on several dimensions:
 - Financial position heading into the downturn
 - Severity of the downturn
 - Program generosity
 - Employer taxes

Duration of borrowing: 2007:Q4–2011:Q2



Source: U.S. Department of Labor, Employment & Training Association.

Note: Duration measured by the number of quarters between 2007:Q4 and 2011:Q2 in which state had an outstanding loan balance. The Virgin Islands falls in the heaviest borrowing group. 15

Financial position heading into the downturn

- Strong relationship between borrowing activity and solvency at beginning of recession
 - Heavy borrowers had an average AHCM (average high-cost multiple) of 0.33 compared to 0.88 for light borrowers and 1.21 for non-borrowers
 - Rhode Island had the lowest AHCM among the NE states (0.37) and Maine the highest (1.64)

Severity of downturn

- Heavy borrowing states faced more severe labor market conditions during the downturn
 - Heavy borrowers had an average total unemployment rate of 8.5—higher than the rates for light borrowers (7.2 percent) and non-borrowers (6.9 percent)
 - Rhode Island had the region’s highest average total unemployment rate over the period (9.9 percent); Maine’s rate (7.1 percent) equaled the regional average

Program generosity

- Borrowing states did not have more generous benefits, on average, but heavy borrowers may have had more generous eligibility criteria
 - All three borrowing groups had similar average replacement rates
 - Heavy borrowers had a higher average reciprocity rate than other groups
 - Rhode Island had above-average replacement and reciprocity rates; Maine had (slightly) above-average replacement, below-average reciprocity

Employer taxes

- Borrowing states had significantly lower average ratios of taxable to total wages than non-borrowers, but not lower tax rates
 - Light and heavy borrowers had average ratios of taxable to total wages of 25.0 and 25.6 percent compared to 34.1 percent for non-borrowers
 - Rhode Island (28.9 percent) and Maine (29.9 percent) had the region's highest average ratios of taxable to total wages; Rhode Island also had region's highest average tax rate

Why were some states so poorly positioned heading into the Great Recession?

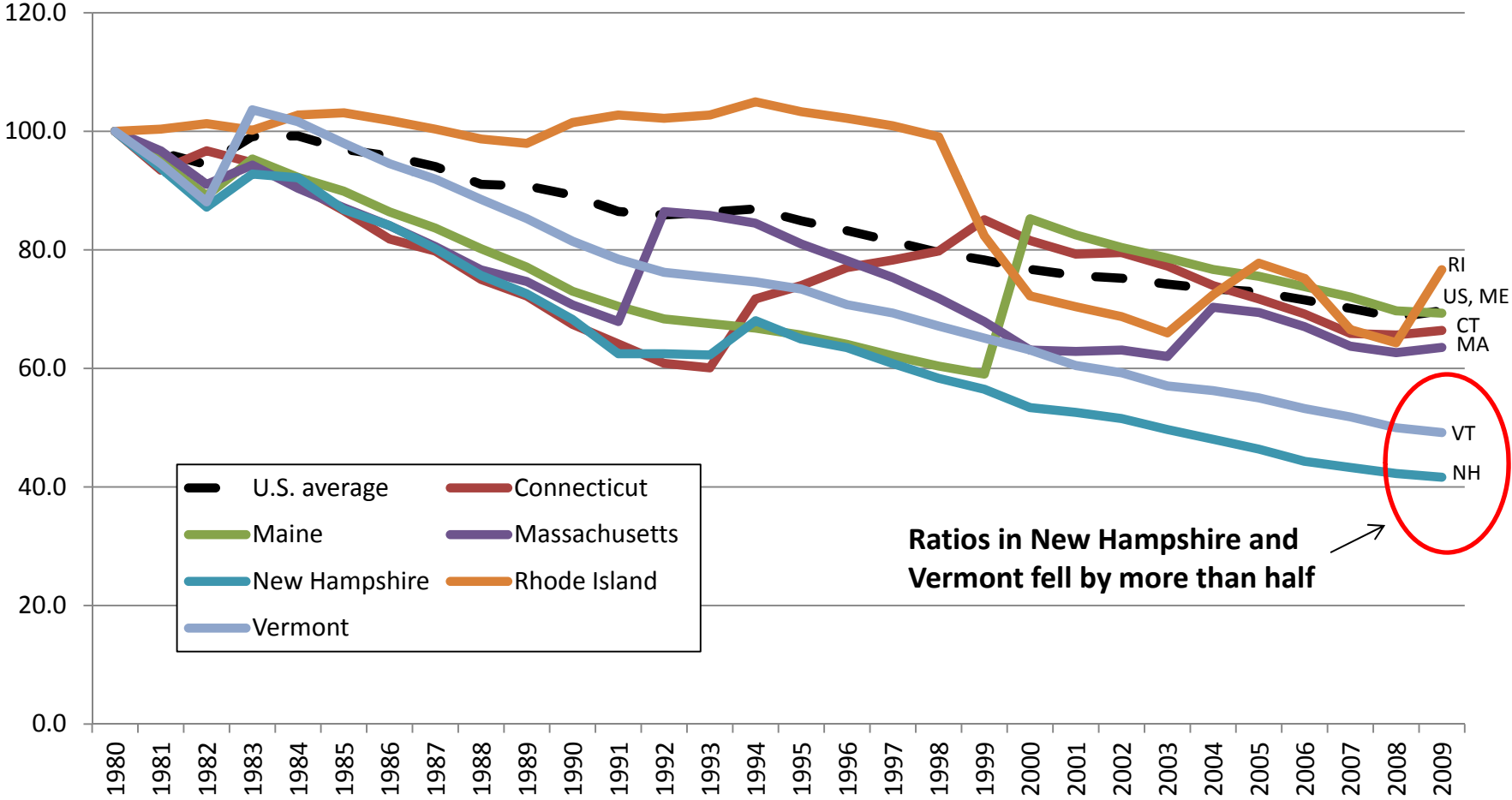
- 2010 GAO report:
 - “Long-standing UI tax policies and practices in many states over 3 decades have eroded trust fund reserves, leaving states in a weak position prior to the recent recession. While benefits over this period have remained largely flat relative to wages, employer tax rates have declined. Specifically, most state taxable wage bases have not kept up with increases in wages, and many employers pay very low tax rates on these wage bases.”
- Between 1980 and 2009, the average ratio of taxable to total wages across all state UI programs fell by 30 percent

What lessons can we learn from the New England state UI programs?

- What hurt various New England states:
 - Erosion of taxable wage bases
 - Unbalanced reforms
 - Chronically low reserve levels
- What helped one New England state:
 - Balanced reforms and good timing

New England lessons: Erosion of the taxable wage base

Ratio of taxable to total wages: 1980-2009



Source and note: U.S. Department of Labor, Employment & Training Administration. Data indexed so 1980 = 100.

New England lessons: Unbalanced reforms

- Vermont
 - In late 1990s and early 2000s the state increased benefits
 - No concurrent changes to taxes
- Rhode Island
 - 1998 reform lowered and “de-indexed” the state’s taxable wage base
 - No concurrent changes to benefits

New England lessons: Chronically low reserve levels

- Massachusetts
 - Commonly freezing rate schedules
- Connecticut
 - Tax rates tied to a low target reserve level

New England lessons: Maine's 1999 reform

- Balanced substance
 - Made minor benefit reductions
 - Raised taxable wage base
 - New method of assigning tax rates to employers
 - Spread contributions more evenly across employers
 - Gave state more control over trust fund inflows
- Good timing
 - Made the reform less painful for employers and allowed the state to build up a cushion of reserves

How (some) New England states reacted to the insolvency in the wake of the Great Recession

- New Hampshire
 - Increased the taxable wage base (over several years)
 - Created new criteria for determining employer tax rates
 - One-week waiting period for benefits
- Vermont
 - Increased the taxable wage base (over several years) and indexed to total wage growth
 - Tightened non-monetary eligibility criteria and instituted a one-week waiting period for benefits

How (some) New England states reacted to the insolvency in the wake of the Great Recession

- Rhode Island
 - Re-indexed the taxable wage base and created a higher base for employers with the most layoffs
 - Reduced benefits by altering the benefit calculation and lowering the maximum benefit

Conclusions

- There is a strong relationship between a state's borrowing activity in the Great Recession and the solvency of its trust fund heading into the downturn
- States that borrowed most heavily also faced higher unemployment rates, on average, than other states
- All borrowing states had, on average, lower ratios of taxable to total wages than states without loans, but did not necessarily have more generous UI benefits

Conclusions

- Erosion of the taxable wage base appears to be an important contributing factor to the solvency issues faced by many states, including those in New England
- Maine's ability to weather the Great Recession seems due in large part to reforms enacted in the late 1990s
- Other examples from New England illustrate the dangers to solvency of:
 - Unbalanced reforms (even if enacted during booms)
 - Policies or practices that lead to chronically low reserve levels

Recommendations

- To improve UI trust fund solvency in the future, policymakers should consider:
 - Raising taxable wage bases and indexing them to growth in total wages
 - Avoiding unbalanced reforms that ONLY increase benefits or ONLY lower taxes
 - Re-examining employer tax rates and trust fund targets