When the Tide Goes Out: Unemployment Insurance Trust Funds and the Great Recession

Lessons for and from New England

April 17, 2012

Jennifer Weiner, Senior Policy Analyst

New England Public Policy Center

Federal Reserve Bank of Boston

Views expressed are the author's and are not necessarily those of the Federal Reserve Bank of Boston or the Federal Reserve System.

FEDERAL RESERVE BANK OF BOSTON™

New England Public Policy Center at the Federal Reserve Bank of Boston

Overview

- Background on UI program
- Borrowing in the Great Recession
- Data comparisons
- Lessons from New England
- Policy options

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:
  - Eligibility tied to prior labor force attachment and circumstances of job separation
  - Benefit amounts tied to previous earnings (subject to a maximum) and typically available for up to 26 weeks
  - Financed by employer taxes

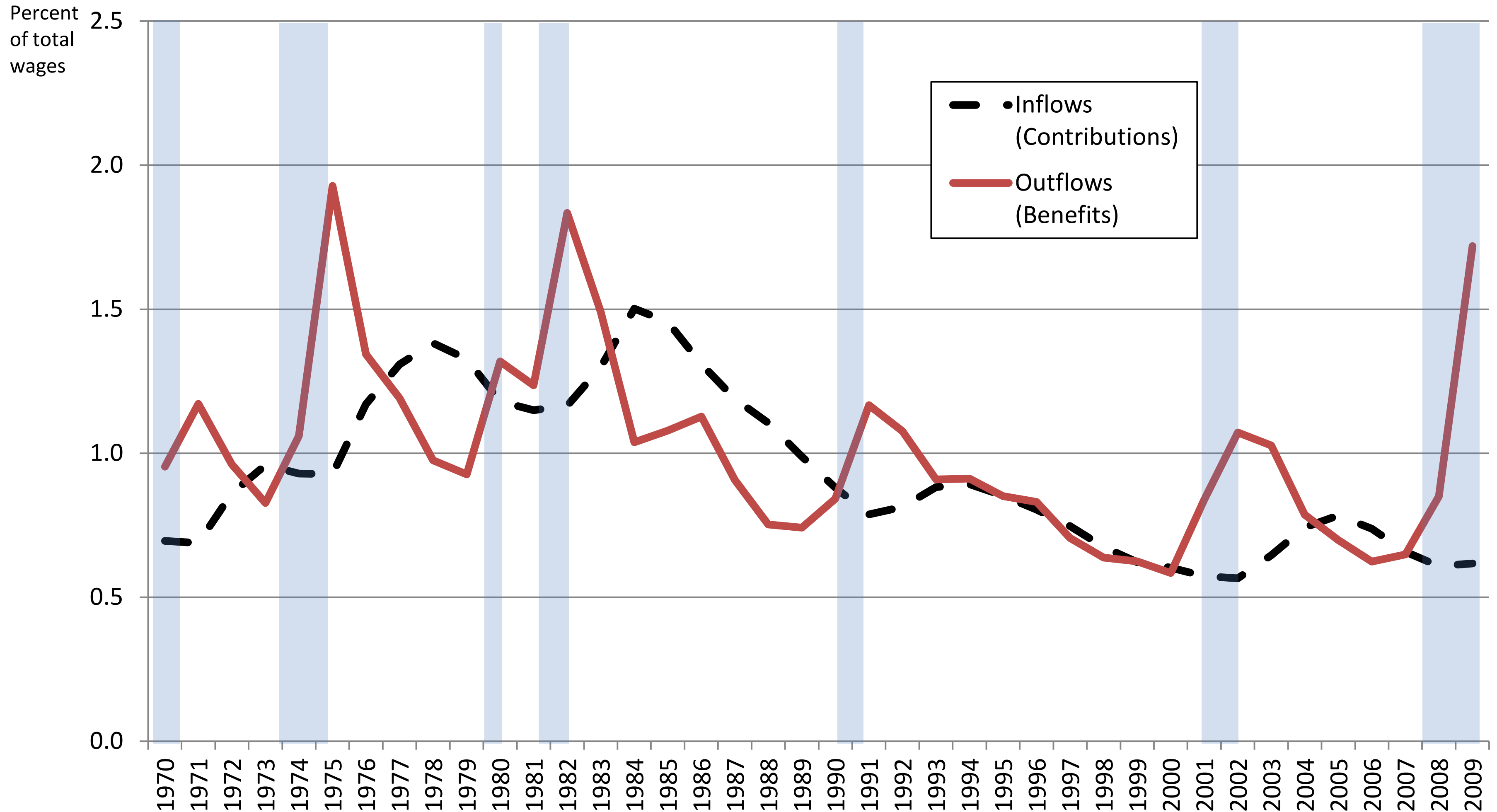
Unemployment insurance (UI): The basics

- Employers pay a per-employee state tax 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

- State UI trust fund accounts:
  - Employer tax payments flow in
  - Benefit payments flow out
  - Inflows (+ interest) - outflows = reserves

UI accounting: Forward funding



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

Borrowing from the federal government

- States can borrow from the federal government if trust fund reserves not sufficient
- "Typical" borrowing rules:
  - Interest-free short term borrowing ("cash-flow" loans)
  - More prolonged borrowing can mean:
    - Interest charges
    - Higher effective FUTA rates

UI borrowing in the Great Recession

- At least 35 states borrowed at some point, 29 still have outstanding loans totaling $39B. What this means:
  - Interest payments
    - Waived in 2009 and 2010
    - First payments due in September 2011 and totaled over $1B, mostly covered by employer taxes
  - Increased FUTA taxes
    - 21 states subject to higher rates 2011, more expected in 2012

Focus on borrowing in New England states

	CT	ME	MA	NH	RI	VT
First loan quarter	Q4:09	NA	Q1:10	Q1:10	Q1:09	Q1:10
Total loan quarters (Q4:07-Q2:11)	7	0	4	2	10	6
Peak loan balance (Q4:07-Q2:11)	$810M	$0	$387M	$23M	$257M	$78M
Peak as % of quarterly wages	3.17	0.00	0.90	0.36	5.54	2.56
Loan balance as of Q2:11	$810M	$0	$0	$0	$222M	$78M
Plan for interest repayment	Employer tax	NA	NA	NA	Employer tax	General fund
First year for FUTA increase	2011	NA	NA	NA	2011	2012

Questions explored in this research

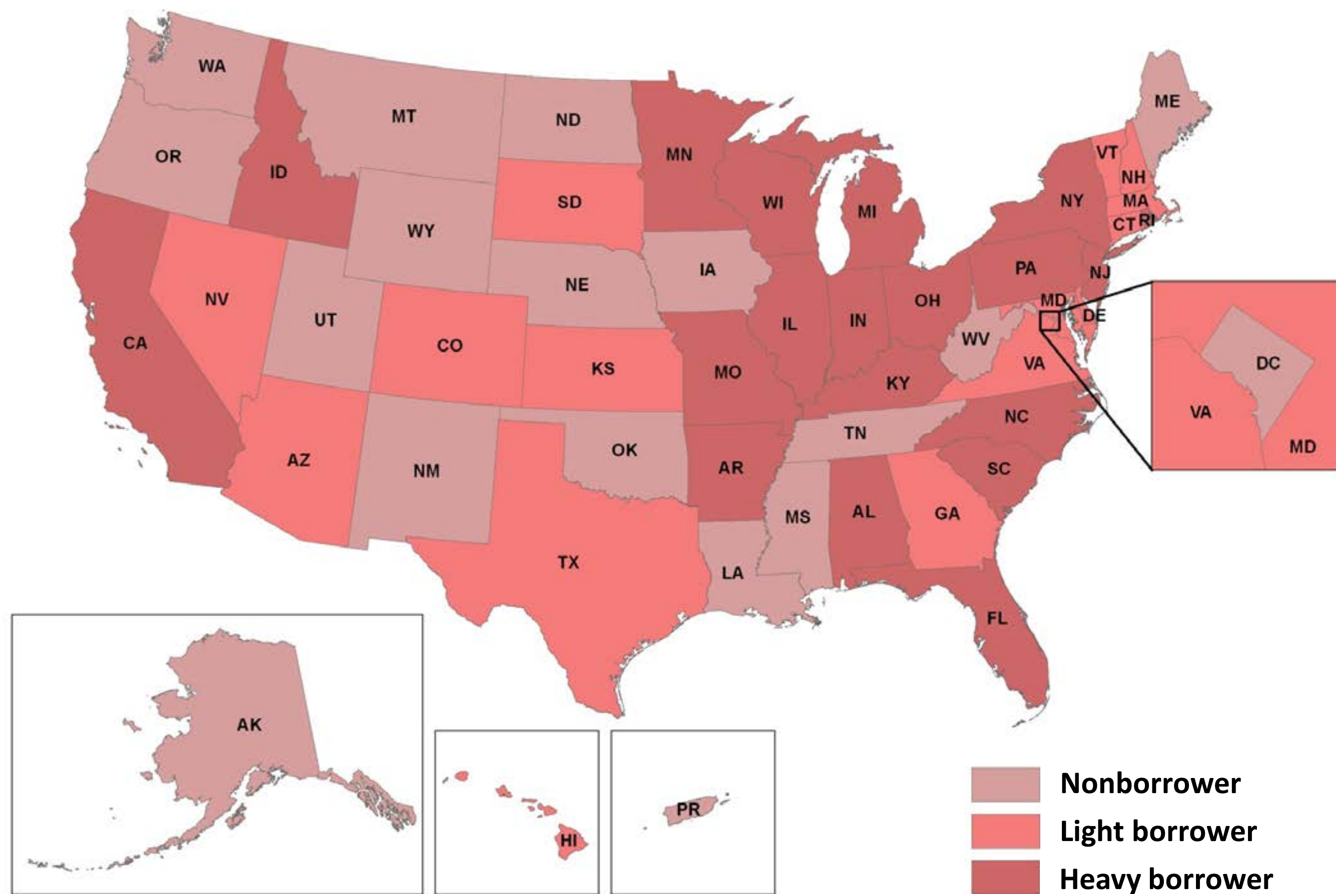
- Why did many state UI program deplete their trust funds during or after the Great Recession, while others did not?
- What trends or reforms contributed to the insolvency (or solvency) of the New England UI programs?

Identifying factors related to solvency: Approach

- Classify states into three groups:
  - Nonborrowers (18 states)
  - “Light” borrowers (15 states)
  - “Heavy” borrowers (20 states)
- Compare groups on several dimensions:
  - Solvency at start of downturn
  - Severity of the downturn
  - Employer taxes
  - Program generosity

Identifying factors related to solvency: Approach

States classified by borrowing duration, 2007:Q4–2011:Q2



Source and note: U.S. Department of Labor, Employment & Training Administration. Duration measured by the number of quarters in the period in which state had an outstanding loan balance. The Virgin Islands, not pictured, fall in the heaviest borrowing group.

Key findings: Solvency at start of the downturn

- Strong relationship between borrowing and solvency heading into downturn
- Solvency experts recommend states have an average high-cost multiple of 1 heading into a downturn

	Non-borrowers	Light borrowers	Heavy borrowers
Average high-cost multiple (Q4:07)	1.21	0.88	0.33

Key findings: Severity of the downturn

- Heavy borrowers, on average, faced higher unemployment during the downturn than other states

	Non-borrowers	Light borrowers	Heavy borrowers
Peak unemployment rate (Q4:07-Q2:11)	9.3	8.9	11.1

Key findings: Employer taxes

- Borrowers (light or heavy) had lower average ratios of taxable to total wages than non-borrowers

	Non-borrowers	Light borrowers	Heavy borrowers
Ratio of taxable to total wages (Q4:06-Q3:07)	34.1	25.0	25.6

Key findings: Program generosity

- No evidence of strong relationship between benefit generosity and borrowing

	Non-borrowers	Light borrowers	Heavy borrowers
Average replacement rate (Q4:06-Q3:07)	36.0	36.2	37.4

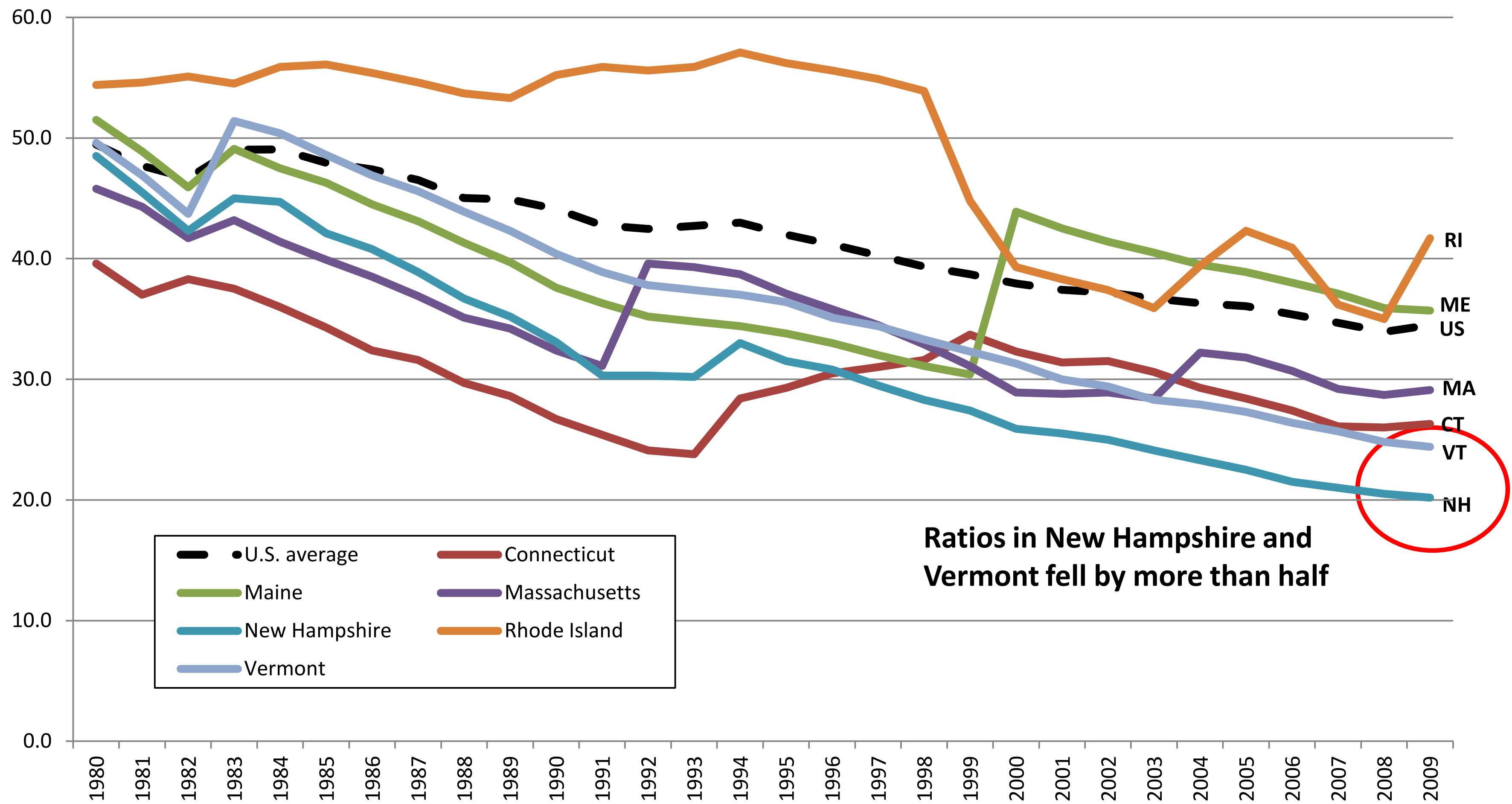
Why were many states so poorly positioned heading into the Great Recession?

- 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 the U.S. fell by nearly one-third

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



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

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
  - Peak HCM (1971-2006): 0.63
  - Years with outstanding loans (1970-2006): 10
  - Likely contributing factor: State's frequent overrides of statutory increases in tax rates
- Connecticut
  - Peak HCM (1971-2006): 0.45
  - Years with outstanding loans (1970-2006): 16
  - Likely contributing factor(s): Tax rate structure and target reserve level

New England lessons:
Maine’s 1999 reform

- Balanced substance
  - Made minor benefit reductions
  - Raised taxable wage base
  - Moved to array method of assigning tax rates
    - Spread contributions more evenly across employers
    - Gave state more control over trust fund inflows
- Good timing
  - Reforms enacted when economy was doing well

Policy options for strengthening UI trust funds

- 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

New England Public Policy Center

Federal Reserve Bank of Boston

600 Atlantic Avenue

Boston, MA 02210

617-973-4257

jennifer.weiner@bos.frb.org

http://www.bostonfed.org/neppc