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A Changing Federal-State Balance in Unemployment Insurance?

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A Changing Federal-State Balance in Unemployment Insurance?

Unemployment insurance (UI) provides temporary partial wage replacement to involuntarily jobless workers who are strongly attached to the labor force. The federal-state UI system was established by the Social Security Act of 1935 during the Great Depression. Despite the severity of the long-term unemployment problem at the time, the UI program started modestly. The original aims were to alleviate hardship during temporary periods of joblessness, maintain aggregate purchasing power during economic downturns, preserve employer-employee relationships, and prevent descent into poverty. States' reluctance to establish programs was overcome by the incentive of a federal tax with a 90 percent credit to states operating conforming UI programs. Through its benefit and financing mechanisms, UI is an automatic stabilizer for the economy. In recessions spending is injected through benefits, and benefit disbursements decline in recoveries. Through the forward funding principle, states accumulate reserves during economic expansions and draw them down during recessions. The UI program has served well its core aims over the years, but the federal-state balance of responsibilities is changing, and current trends in funding and benefit duration threaten the countercyclical strength of state programs.

Yang, Lasky, and Page (2010) of the Congressional Budget Office (CBO) rated UI as the best of 11 possible countercyclical policy measures because of its timeliness, strength, and temporary nature. Besides replacing lost earnings to households, they estimate UI job creation strength to be between two and five times that of infrastructure spending. During the recent Great Recession, UI was particularly important in alleviating hardship and serving as a countercyclical mechanism. Acs and Dahl (2010, p. 8) of the CBO estimated that "in 2009, the poverty rate was 14.3 percent. Without UI benefits, it would have been 15.4 percent."

In 2009 states paid $79 billion in regular UI benefits, while the federal government provided $49.2 billion in emergency and extended benefits. The federal support included the full $6.1 billion cost of benefits paid through the permanent federal-state extended benefits program that is normally financed 50-50 together with the states. Despite federal largess, the Great Recession exhausted the majority of state accounts in the Unemployment Trust Fund. Many states had not accumulated adequate reserves before the downturn and were forced to borrow from the Federal Unemployment Account. Figure 1 shows the federal shares of total UI benefit payments in years around recessions dating back to

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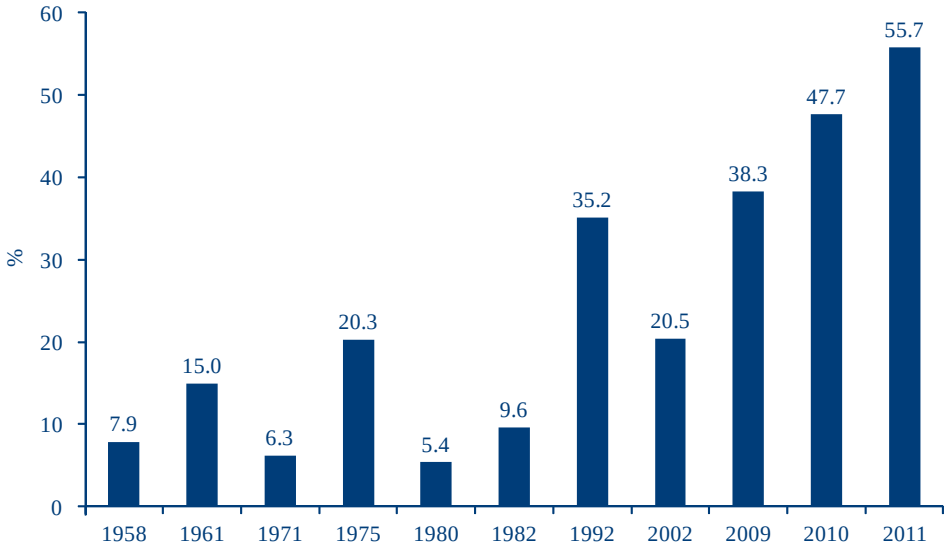
Figure 1 Federal Shares of Total Unemployment Insurance Benefit Costs in Recession Years



SOURCE: http://www.ows.doleta.gov/unemploy/hb394.asp (accessed January 14, 2013).

1958. The federal shares in the past three years were enormous, reaching 55.7 percent in 2011.

The UI system was designed to be self-financing and started with a strong financial foundation having relatively high tax rates and modest benefits. The Federal Unemployment Tax Act (FUTA) in 1939 set the total tax rate at 3 percent on the first $3,000 earned by each employee—the same as Social Security at the time. A 90 percent FUTA credit meant a tax rate of 2.7 percent paid into state reserve accounts for benefits, with 0.3 percent paid into federal accounts for program administration, loan reserves, and employment services. In 1939, most states paid weekly benefits equal to half the weekly wage up to a maximum of $15 for up to 16 weeks. Some offered as many as 26 weeks (Table 1). It was common at that time for states to require waiting periods between 2 and 4 weeks as a type of insurance copayment covered by the worker.

After World War II, reserves accumulated and benefits improved. Sufficient forward funding of benefits permitted development of state financing systems that recovered charges three to five years after payment when the economy was again in the expansion phase. By the late 1950s nearly all states provided up to 26 weeks of compensation. In 1959, one waiting week was standard in all but five states. In the 1960s, system reserves continued to rise and 26 weeks became the minimum potential compensable duration in all states.

As social insurance, UI does not replace all lost wages. Instead, wage replacement aims to cover most nondeferrable expenses for a median household. Various strands of research all find the optimal replacement rate at about 50 percent of lost wages. That rate is said to balance socially adequate income replacement against possible work disincentives. Research also suggests that the common practice of a fixed weekly benefit amount for up to 26 weeks during joblessness would tend to overcompensate short spells and undercompensate long spells of unemployment (O'Leary 1998). Recessions starting after the first OPEC oil embargo in 1973 put a severe strain on state UI financing systems. Actions and inactions by the state and federal partners in response to successive crises over the years have tipped the balance toward a larger federal role in the system.

To earn their FUTA credit, states are required to experience rate taxes paid by employers based on their UI benefit charges, and to have taxable wage bases at least as high as the FUTA level. The FUTA tax base has been increased only three times: to $4,200 in 1972, to $6,000 in 1978, and to the current level of $7,000 in 1983 by President Reagan. That current level is only 6.2 percent of the $113,700 taxable wage base for Social Security. Since many states set their maximum taxable wage base at or near the FUTA level, the average tax on total payrolls has declined dramatically, and states often strain to cover ineffective charges to employers perpetually stuck at the maximum tax rate. Such employers have benefit charges exceeding contributions every year, and are subsidized by employers whose taxes vary within the limits of the tax rate range. Thirty-five states currently have UI taxable wage bases at or below $15,000.

The recessions of 1975, 1980, and 1982 resulted in significant levels of borrowing by states to pay UI benefits, and the share of unemployed receiving UI continued a downward trend through the early 1980s. Federal actions to raise triggers for the extended benefits, and state actions to tighten eligibility requirements and enforce active job search all curtailed recipiency. After the industrial restructuring and massive permanent worker displacements in the

Table 1 Benefit and Tax Parameters of State Unemployment Insurance Systems over Time

	Max weeks		Waiting weeks		Taxable wages ($)		Average tax rates (%)	
Year	Low	High	Low	High	Low	High	Total	Taxable
1939	13	26	2	4	3,000	3,000	2.66	2.72
1959	18	34	0	1	3,000	4,200	1.06	1.71
1979	26	39	0	1	6,000	11,200	1.26	2.67
1999	26	30	0	1	7,000	27,500	0.56	1.77
2012	20	30	0	1	7,000	38,800	0.90	3.40

SOURCE: http://www.ows.doleta.gov/unemploy/statelaws.asp (accessed January 14, 2013).

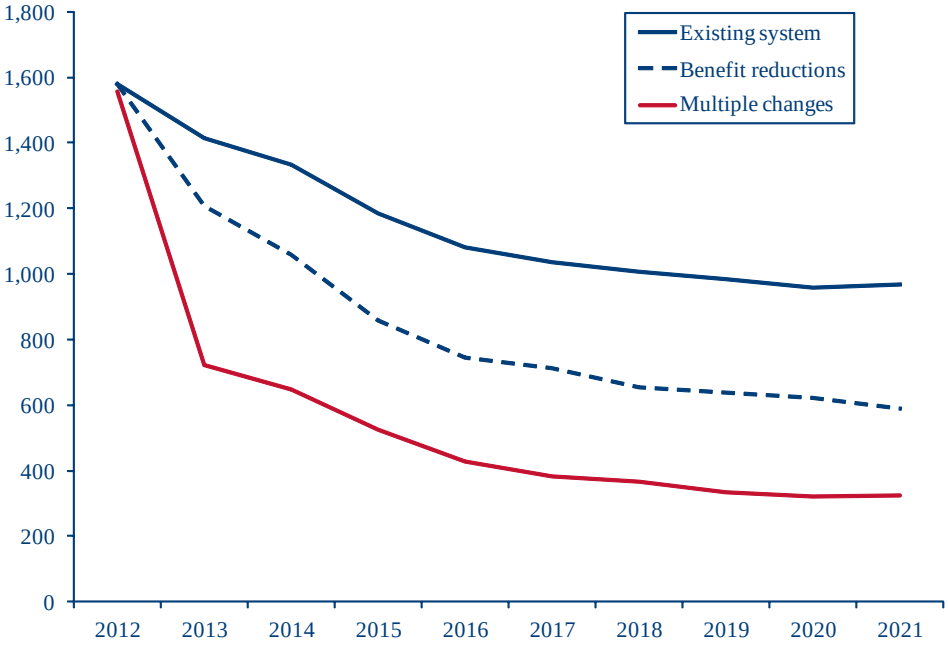
1980s, both voluntary and involuntary part-time work expanded. Pressure to provide UI access for these workers restrained increases in UI earnings requirements, and this policy posture was activated through incentives provided for UI modernization in the American Recovery and Reinvestment Act of 2009. However, the scale of state UI borrowing in the Great Recession forced states to undertake dramatic UI program reforms. In 2011, interest payments were made on loans by 29 state UI programs. By 2012, there remained 19 state programs with loans outstanding for at least two consecutive years. Those states were subject to FUTA credit reductions ranging from 0.3 to 1.5 percentage points. Rather than enacting reforms to enhance UI fiscal integrity, many states have accepted the FUTA credit reductions that rise by 0.3 percentage points per year until the outstanding loans are paid off. A problem with this strategy occurs after the loan is paid off—the offset falls to zero and the conditions causing the shortfall remain unchanged.

Five states adopted UI reforms in 2010; of these, four states raised their taxable wage bases, and two enacted benefit reductions. In 2011, six states enacted UI program changes emphasizing reduced benefit entitlement; all six cut their maximum potential durations of benefits to 23 or fewer weeks (Vroman 2011). These actions were probably influenced by the federal benefits extension for 2011 that prohibited reductions in weekly benefits but did not address durations. It has been more than 60 years since potential durations have been less than 26 weeks in any state. In 2012, Georgia implemented a system with maximum potential duration up to 20 weeks if unemployment is 9.0 percent or higher, with the maximum falling by 1 week for each 0.5 percentage point drop in the state total unemployment rate reaching a minimum of 14 weeks if unemployment is 6.5 percent or lower.

Preliminary data from a proposed federal Employment and Training Administration report on the actual quarterly distributions of UI benefit receipt are used to shed light on the effects of shorter potential durations. In a representative state, with variable entitled duration, an average of 43.0 percent of beneficiaries exhausted the 26-week maximum entitlements between 2006 and 2011. Each of the benefit durations between 25 and 10 weeks were experienced by 3–4 percent of the beneficiaries, and a total of 1 percent had durations less than 10 weeks. Using an econometric benefit financing model, we simulated the effect on total UI payments under the assumption that state unemployment gradually declines from 9.5 percent in 2012 to 5.8 percent in 2021. Adopting the declining maximum duration feature alone, annual UI benefit payments will be 39 percent lower in 2021. We also simulated the effect of this change together with two others: 1) fixing the maximum weekly benefit amount at 70 percent of its current dollar level; and 2) changing the benefit formula from being based on the high quarter only to the two most recent quarters—which includes the Ashenfelter income dip for displaced workers. This second bundle of changes is simulated to produce UI benefit payments 67 percent lower in 2021 than would result under the current system (Figure 2). Such packages of benefit changes dramatically reduce the alleviation of hardship caused by unemployment, and seriously weaken the countercyclical strength of UI benefits.

The UI system served an important stabilizing function for the economy during the recent deep and protracted recession. However, federal action and state responses to accumulated debt threaten the countercyclical strength of the federal-state system. Reforms proposed by the White House and the Senate to raise the FUTA wage limit to $15,000 would broaden the tax base in the majority of states and should improve forward funding of the system. A House proposal to federally pay about $31 billion in state debts would reinforce current trends of declining state fiscal preparedness. Rather than focusing mainly on reduced benefit provisions to address fiscal difficulties, states should adopt balanced packages of revenue and benefit reforms. In addition to raising the FUTA tax base, the federal partner should institute minimum standards on weekly benefit levels and durations, and also tie potential durations of any future federal emergency benefits to the existing state maximum durations. For example, a state providing up to 26 weeks would get 13

Figure 2 Projected Benefit Payments under Existing and Alternative Declining Duration UI Systems ($, millions)



SOURCE: Author's computations.

weeks of federal temporary benefits, but if the state maximum were 20 weeks the federal supplement would be 10 weeks.

A much neglected potential reform on the benefit side would be to institute waiting periods of 2–4 weeks, with the duration of the wait depending inversely on the aggregate level of unemployment. Current UI take-up rates among the eligible unemployed range from 60 to 80 percent depending on job market conditions. A somewhat longer waiting period will reduce program entry by those with ready reemployment options, and help to preserve the income security strength of the system for those who are involuntarily jobless for 4, 5, or 6 months. This approach could help preserve benefit adequacy while fiscal reforms broaden the tax base and range of rates to restore the experience rating principle. Better cost recovery of benefit charges will assure that final prices of goods and services more properly reflect the full cost of unemployment risk in their production.

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Economic and Psychological Consequences of Long-Term Unemployment

On April 1–2, 2011, the UCLA Institute for Research on Labor and Employment (IRLE) hosted an Upjohn Institute–sponsored conference on long-term unemployment, its causes and consequences, and policies to mitigate it. With a loss of 7.9 million jobs from the start of the Great Recession in December 2007 until jobs started to consistently increase in October 2010 (Bureau of Labor Statistics 2013a), the recession of 2007–2009 resulted in far greater job losses in the United States than any other recession in recent history. Thus, the conference, with participants from the United States, Canada, and Europe, was held in response to the jobs crisis that began with and followed from the Great Recession in the United States and the severe economic downturn felt around the world.

The UCLA-IRLE conference was held 21 months after the recovery from the Great Recession had begun, and the United States was still mired in a severe jobs crisis, having created only 1.1 million jobs during the 21 months from July 2009 through March 2011. While this job growth was welcomed, it did little to alleviate unemployment, as it would have taken the creation of more than 2 million jobs in this time period merely to keep up with the growth in the working age population. In addition, in March 2011, the month prior to the conference, 8.4 million workers were working part time when they wanted to have full-time positions. The unemployment rate was 8.8 percent, and 45.5 percent of the unemployed found themselves out of work for 6 months or more. One-third of the unemployed had been looking for work for at least one year (Bureau of Labor Statistics 2013a,b).

The book *Reconnecting to Work: Policies to Mitigate Long-Term Unemployment and Its Consequences*, published recently by the Upjohn Institute, is based on the proceedings of the 2011 conference. Although the employment situation in the United States has since improved somewhat, with unemployment dropping to below 8 percent in September 2012 for the first time since January 2009, this book is still all too relevant (Bureau of Labor Statistics 2013b). The jobs deficit is worse and jobs recovery slower following the Great Recession than in the five preceding recessions (see Figure 1).

While the unemployment rate has in fact declined, the country still faces a jobs deficit of 4 million compared with the number of jobs in the economy in December 2007 (plus more than 5 million jobs that should have been created since the start of the recession to keep up with the growth in the working age population). The rate of job growth has been increasing, but not fast enough—at the current rate, it will take until the next decade to alleviate the jobs deficit created by the recession (Baker 2013). Moreover, despite the recent improvement in the unemployment rate, the broader measure of unemployment that includes individuals working part time for economic reasons and those who are only marginally attached to the labor force has remained much higher—14.4 percent in December 2012. Also in that month, there were 7.9 million people who were working part-time for economic reasons. While there were 500,000 fewer involuntary part-time workers in December 2012 than when the conference was held in April 2011, there were still 3.3 million more of these workers that month than when the recession began in December 2007. Furthermore, long-term unemployment remains a serious problem in the United