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U.S. Unemployment Insurance: Progress and Prospects

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[Editor's Note: This article is the fifth in a series on "Research Questions for the New Millennium." The series aims to identify research needed to inform employment policy in the near future.]

The federal-state system of unemployment insurance (UI) in the United States was established by provisions in the Social Security Act of 1935. Public acceptance of and political initiative for the system emerged from the widespread hardship resulting from high unemployment in the Great Depression. The original UI provisions aimed to partially reduce lost income for involuntarily unemployed workers, to reduce the dispersal of skilled workers when employers make temporary layoffs, to help maintain aggregate purchasing power during economic downturns, and to prevent the breakdown of general labor standards during such periods.

As we enter the 21st century, the longest economic expansion since World War II is continuing, and labor shortages are developing in many areas. In addition to meeting existing obligations, the UI system faces an added list of challenges. This article offers a brief overview of the UI system as it operates today and suggests topics for research which could inform the further development of UI.

Eligibility and Benefits

Unemployment insurance is social insurance. It combines insurance principles with considerations of social adequacy. UI is intended to partially replace lost earnings for involuntarily unemployed persons with sufficient prior employment, who are able, available, and actively seeking work.

As insurance, UI requires that premiums be paid in advance through employer taxes on wages earned in the prior year. Initial eligibility requires that earnings in UI-covered employment exceed a state-specified minimum. States usually require at least $1,000 in earnings, with a higher level required for higher benefits.

Balancing social adequacy and work incentives, state laws provide that UI will replace about one-half of prior wages, subject to a maximum and minimum, for up to 26 weeks. In 1999, the weekly benefit amount averaged $200. During the past half-century, UI has replaced on average one-third of lost wages (Table 1, column 1) among those who qualify for benefits.

Research suggests that UI payments slightly prolong unemployment spells. Evaluation of strategies to improve reemployment incentives has informed the adoption of policies that target job search workshops and self-employment assistance. Beginning in 1994, the Worker Profiling and Reemployment Services (WPRS) system required special job search training for those identified as being most likely to exhaust UI benefits. Lessons from WPRS can inform the targeting of services at newly established one-stop career centers in workforce investment areas.

Table 1 Benefit and Financing Trends in the U.S. Federal-State UI System, for Selected Years 1938-1998

Year	(1) Wage replacement rate[a] (%)	(2) UI benefit payments as a % of GDP	(3) Reserve ratio[b] (%)	(4) Average UI tax on covered payrolls (%)
1938	43.1	0.46	4.22	2.69
1943	33.6	0.03	7.13	1.86
1948	34.1	0.30	7.91	1.01
1953	32.3	0.26	6.41	0.93
1958	35.3	0.77	3.99	0.84
1963	34.6	0.46	2.88	1.34
1968	34.3	0.23	3.54	0.76
1973	36.1	0.30	2.13	0.99
1978	36.4	0.35	0.55	1.41
1983	37.2	0.52	0.00	1.20
1988	34.9	0.30	1.71	0.96
1993	36.0	0.34	1.25	0.90
1998	32.9	0.23	1.51	0.62

[a]Wage replacement rate is the average UI weekly benefit amount divided by average weekly wage in UI covered employment.
[b]Reserve ratio is accumulated holdings in UI benefit trust funds divided by total payrolls in UI covered employment x 100.
SOURCE: U.S. Department of Commerce. *Survey of Current Business*. Washington, D.C. and U.S. Department of Labor. *Unemployment Insurance Financial Data: ET Handbook No. 394*. Washington, D.C.: Employment and Training Administration.

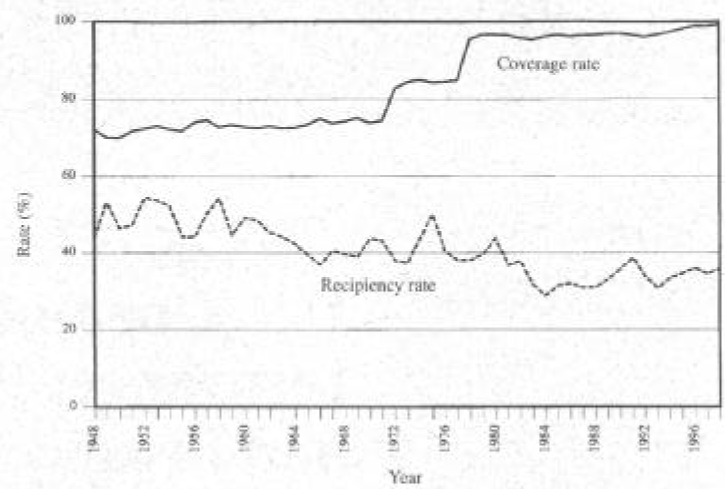
The original focus of the UI system on prime-age, full-time workers in a labor surplus economy remains largely unchanged to this day. However, in the current labor shortage situation, broadened UI eligibility for part-time, contingent, and self-employed workers could increase labor force participation and help ease tight labor markets. Research should investigate the financing costs and effects of permitting continued UI eligibility for those only seeking return to part-time work, as well as special reimbursable benefit arrangements for self-employed and contingent workers.

The U.S. Department of Labor recently drafted regulations to allow states to use UI reserves for paying benefits to households in which parents have chosen to take parental family leave. This essentially expands UI eligibility to include beneficiaries who are not actively seeking work. The impact of such expansions on the ability of the UI system to finance its core objectives should be carefully evaluated.

Coverage and Recipiency

UI coverage has steadily expanded over the years to encompass virtually all full-time permanent wage and salary workers (Figure 1). Initially, only employers with eight or more workers were covered; that was relaxed to four employees in 1954, and to one employee in 1970. In the early 1970s, nonprofit firms and state and local governments became covered. As coverage steadily expanded, the rate of UI recipiency gradually fell. Beneficiaries now constitute only about 35 percent of all unemployed (Figure 1).

Figure 1 UI Coverage and Recipiency Rates in the U.S., 1948–1998



SOURCE: U.S. Department of Labor, 2000. *Unemployment Insurance Financial Data: ET Handbook No. 394*. Washington, D.C.: Employment and Training Administration (http://www.itsc.state.md.us/ui _manage/HDBK394_99fnkus.html) and U.S. Department of Labor, 2000. *Employment and Earnings*. Washington, D.C.: Bureau of Labor Statistics (http://www.bls.gov/cpsatabs.htm).

Even among those eligible for benefits, only about two-thirds bother to collect. In addition to raising questions about social adequacy, low recipiency may weaken the counter cyclical potential of the federal-state UI system. Increased UI recipiency has become a major objective of the U.S. Department of Labor. UI has acted as an automatic stabilizer for the economy. In times of recession, aggregate UI payments have risen to more than three-quarters of 1 percent of gross domestic product (GDP), while automatically falling below one-quarter of 1 percent of GDP in years of low unemployment (Table 1, column 2).

Over the years, the countercyclical effect of UI has frequently been supplemented by temporary federal programs that extended benefits beyond 26 weeks. Following high unemployment in the early 1980s, the federal government instituted a permanent, federally funded, extended benefits program. Nonetheless, during the 1991 recession, another temporary federal extended benefits program was enacted. Research about how to ideally structure and finance an extended benefits program should continue.

Financing Benefits

UI was established through a federal tax levied on employer payrolls, with 90 percent of the revenue returned to states that establish and operate UI programs consistent with requirements in the federal law. There is wide variation among states in UI provisions, but all comply with federal statute as monitored by the U.S. Department of Labor.

A key federal requirement is that taxes be experience-rated, meaning that tax rates move in tandem with a firm's layoffs and UI benefit charges. Research finds that when experience rating operates without restriction, it acts to stabilize employment. However, tax rate maximums, minimums, and time lags in tax adjustment weaken the response.

The benefit financing system is designed to minimize the tendency of UI taxes to reinforce economic contractions. Reserves are replenished gradually by tax contributions after they are drawn down by benefit payments. The most severe financial strain ever experienced by the system occurred in 1975, when benefits totaled 2.2 percent of covered payrolls. From 1975 to 1987, total system reserves never exceeded 1 percent of covered payrolls. By 1982, UI benefit trust funds were completely exhausted (Table 1, column 3). The response among states was tightened eligibility, which conserved funds but contributed to diminished recipiency rates.

Recent years have witnessed a slow and modest recovery in system-wide reserves. As a proportion of total covered wages, UI taxes have hovered around 1 percent, being well below this level in recent years after a long economic expansion (Table 1, column 4). There are no strong incentives for states to provide significant forward financing of benefits, and the U.S. Department of Labor is moving toward a first-time relaxation of reserve adequacy guidelines. Indeed, a few states have moved to zero tax rates for employers having a positive balance. Research into the effects of broadening the federal taxable wage base on each worker's earnings from $7,000 per year could help inform benefit finance policy.

Administration

Unemployment tax collections retained by the federal government are used to finance program administration through grants to the states and to make loans to the states when liquidity problems arise. Grants for administration are done by a formula based on workload factors such as the number of UI claims, appeals, and covered employers.

UI tax receipts are held in the Unemployment Insurance Trust Fund (UTF), which is part of the unified federal budget. Federal budget deficits through the late 1990s induced the federal government to conserve funds, while the states claimed that federal holdings for administration were state entitlements that should be distributed.

Research has suggested that to encourage high-quality service, efficient low-cost administration, and continuous quality improvement, the administrative funding mechanism should 1) be based on the quality of service as measured through a simple monitoring system operated by the federal partner to assess state practice, and 2) permit states to retain unspent financial grants. Such a system should encourage UI taxpayers to monitor administrative efficiency, so as to increase the share of administrative grants retained for other uses including benefit payments.

States have increasingly viewed the administration of UI as simply a disbursement function. Federal quality control random audits identified failure to satisfy the "actively seeking work" requirement (or "work test") as the prime source of payment errors. States have improved the timeliness and accuracy of payments, but to do so they have often weakened the work test that linked UI to reemployment efforts of the public employment service.

Mechanisms to encourage return to work may be further weakened by telephone systems for initial and continued UI claims. The use of such systems is expanding rapidly, and Internet-based systems are appearing. Telephone claim systems could affect both entry to the UI system and the duration of benefit receipt. These are important policy questions which are now just beginning to receive research attention.

Conclusion

Given the present and likely future labor shortages facing U.S. employers, additional changes in UI that promote reemployment and labor force participation should be studied. Added labor supply might be forthcoming if eligibility conditions were changed to permit UI access for part-time, part-year, and self-employed workers. Research suggests that labor force participation for all these groups is more responsive to UI entitlement than that for prime-age wage and salary workers.

A severe recession has not tested UI financing and claims processing capacity in nearly 20 years. In preparing for the inevitable next recession, the issue is not only the adequacy of UI reserves, but the sufficiency of telephone claims and other UI administrative mechanisms in the new one-stop environment for public employment services.

Since it was first established, the federal-state UI system has provided income replacement for millions of jobless workers and security for countless others who succeeded in the labor market knowing they had earnings insurance to fall back on. UI has become such an integral part of workplace decisions that it is taken for granted. The narrow aim of providing income security for workers is a crucial one. Achieving this at minimal cost of forgone private investment is a huge challenge. As a wealthy society, we may collectively choose to pursue other goals. We should also recognize that the narrowly focused and self-financed UI system has served its function well.

Christopher J. O'Leary is a senior economist at the Upjohn Institute.

Suggested Reading

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