

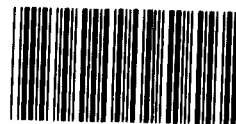
GAO

Report to the Chairman, Senate  
Committee on Finance, U.S. Senate

September 1993

# UNEMPLOYMENT INSURANCE

## Program's Ability to Meet Objectives Jeopardized



149904

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United States  
General Accounting Office  
Washington, D.C. 20548

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**Human Resources Division**

B-253406

September 28, 1993

The Honorable Daniel Patrick Moynihan  
Chairman, Committee on Finance  
United States Senate

Dear Mr. Chairman:

In response to a request from the former Chairman, Senate Committee on Finance, this report presents the results of our review of the Unemployment Insurance (UI) program. It contains information on the factors contributing to the decline in UI beneficiaries and the effect this decline has had on the program's ability to meet its objectives.

Copies of this report are being sent to appropriate House and Senate committees; the Secretary of Labor; the Director, Office of Management and Budget; and other interested parties.

This report was prepared under the direction of Linda G. Morra, Director, Education and Employment Issues, who may be reached on (202) 512-7014 if you or your staff have any questions. Major contributors to this report are listed in appendix V.

Sincerely yours,

Janet L. Shikles  
Assistant Comptroller General

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# Executive Summary

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## Purpose

More than 97 percent of all wage and salary workers are covered under the Unemployment Insurance (UI) program. However, the proportion of unemployed workers who applied for and were deemed eligible to receive unemployment benefits has declined by one-fifth since the late 1970s to about 39 percent. This decline has raised concerns that the UI program may no longer be meeting its primary objectives of (1) providing a temporary and partial wage replacement to unemployed workers and (2) helping to stabilize the economy during recessions.

The Chairman of the Senate Committee on Finance asked GAO to determine (1) the factors contributing to the decline in UI beneficiaries and (2) the effect of this decline on the ability of the program to meet its objectives.

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## Background

The UI program was established in the 1930s to provide temporary assistance to workers with substantial work histories, with the expectation that they would eventually return to their former jobs. Some analysts have maintained, however, that the system developed to address the problems of the 1930s has not kept pace with long-term economic changes. The UI system now operates in a labor market that differs markedly from that of the past. Increasingly, U.S. businesses are reducing the size of their work forces, global competition is transferring jobs to other countries, and improved technology is eliminating some positions. As a result, unemployed workers are without jobs for longer periods, and many positions are lost forever. Forty-four percent of the workers who were displaced during the previous four recessions returned to their former positions, compared with 15 percent who expected to do so following the last recession.

The UI system operates as a partnership between the federal government and the states and provides for the payment of regular benefits to unemployed workers as well as extended benefits during high unemployment. Federal and state payroll taxes on employers finance the program.

The UI program originally operated as a self-financing, forward-funded system under which the states accumulated funds during periods of rising economic activity to pay benefits during economic downturns. The states did a fairly good job of maintaining reserves during the first four decades of the program. However, because of the high unemployment caused by three major recessions during the 1970s and early 1980s, increased benefit

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expenditures, and the creation of an extended benefits program, many states depleted their trust funds and had to borrow from the federal UI loan account to pay benefits.

The percentage of unemployed workers who receive unemployment benefits usually peaks during recessionary periods. During the recessions of the 1950s, 1960s, and 1970s, the proportion of the unemployed who received benefits typically rose to about 50 percent. However, the peak rates experienced since then are substantially lower despite high unemployment rates. Only 43 percent of unemployed workers received benefits during the 1980 recession and only 37 percent during the 1981-82 recession. The percentage increased slowly after 1984 but remained at historically low levels until unemployment began increasing in 1990 as the economy again entered a recession. The 1990-91 recessionary period showed a more typical pattern, with an increase in the percentage of benefit recipients as unemployment increased. Nevertheless, at 39 percent, a substantially lower portion of unemployed workers received benefits than those during earlier recessions.

Previous research on the decline in reciprocity has concentrated on the demographics of the unemployed and laws affecting eligibility and benefit levels. GAO developed a simultaneous equation regression model that goes beyond previous studies and demonstrates the interaction between state trust fund balances, UI reciprocity rates, law changes, and the demographics of the unemployed. In addition, GAO judgmentally selected seven states to visit—California, Colorado, Florida, Kentucky, Massachusetts, Michigan, and New Hampshire—and analyzed the effect that changes in state UI laws, from 1978 to the present, had on the unemployed population being served. GAO also estimated the aggregate effects of changes in benefit payments and analyzed national survey data to determine changes in the total unemployed and UI recipient populations between 1980 and 1990.

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## Results in Brief

GAO's analysis demonstrated that the deteriorating financial status of state trust funds ultimately affected the proportion of the unemployed who received unemployment benefits. GAO found a complex relationship in which declining trust fund balances were associated with law changes that restricted program eligibility and lowered wage replacement rates. These changes, in turn, while helping to improve the financial condition of state trust funds, led to a smaller proportion of unemployed workers receiving UI benefits.

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The UI program objectives are no longer being met to the extent they were during the program's first four decades and may need to be assessed in the context of today's labor market. GAO's estimate showed that, if the same proportion of unemployed workers had received comparable benefit payments during the 1990-91 recessionary period as during the 1974-75 recession, about \$20 billion more in unemployment benefits would have been available to stabilize the economy and maintain the incomes of the unemployed. Nonetheless, unemployment benefits were an important factor in helping to keep an unemployed worker's family above the poverty line, and they became even more important when poverty rates for unemployed workers increased between 1980 and 1990. However, the decline in UI reciprocity over that time is likely to have contributed to the poverty status of 260,000 people in 1990.

The Congress established the Advisory Council on Unemployment Compensation to consider whether the current UI objectives are still relevant and to advise the Congress on the role the program should play in ameliorating the adverse effects of unemployment and recession. The Advisory Council has the opportunity to address the long-term changes that have occurred in the economy and their impact on the UI system.

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## GAO Analysis

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### Factors Contributing to Declining Reciprocity

Declines in state UI trust fund solvency status have been associated with declines in the percentage of unemployed who receive UI benefits. Continued state borrowing, coupled with extended benefit payments during long periods of high unemployment, resulted in negative balances in the overall UI system from the mid-1970s to the mid-1980s. The Congress responded by enacting several laws in the early 1980s that made it more expensive for states to borrow from the federal government. These changes included a federal surtax on employers and interest charges on federal loans to states. States, in turn, initiated changes to state UI laws to address, in part, concerns about the solvency of their trust funds.

GAO's analysis showed, and its work at seven states confirmed, that states with declining or insolvent trust funds were likely to make it more difficult for unemployed workers to qualify for benefits and to reduce the portion of wages of former workers replaced by unemployment benefits. States that increased the qualifying requirements or reduced their benefit amount

provided benefits to a lower proportion of their unemployed. UI officials in five of the seven states verified that the adequacy of their trust fund was a driving force behind their changes. Although the other two states did not relate their changes to trust fund status, they too implemented changes that coincided with declining trust fund balances and trust fund insolvency. An analysis by Michigan officials showed that changes to Michigan's work experience requirement—making it more difficult to qualify for benefits—reduced the number of unemployed workers receiving benefits by about 11 percent, affecting an average of 43,000 workers in each of 3 years analyzed.

Other factors, related to fundamental changes that have occurred in the work force during the past few decades, also influenced the percentage of unemployed workers receiving UI benefits. Long-term unemployed workers now make up a greater proportion of the unemployed population, meaning that many eventually exhaust their unemployment benefits and, thus, contribute to a reduced reciprocity rate. Similarly, the percentage of manufacturing jobs (with relatively high reciprocity rates among the unemployed) has been declining, whereas the percentage of service-sector jobs (with relatively low reciprocity rates) has been increasing. Employers are also hiring more temporary and part-time workers who are less likely to meet the eligibility requirements for unemployment benefits because their jobs do not pay enough or enable them to work long enough.

State officials cited other factors as contributing to the decline in reciprocity. For example, they said some employers control employee work schedules and earnings to ensure that they do not meet the qualifying requirements. GAO did not verify the extent to which such actions are occurring.

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**Unemployment Benefits  
Reduce Likelihood of  
Poverty**

The receipt of UI benefits was an important factor in keeping unemployed workers above the poverty level. While the poverty rate for unemployed workers increased between 1980 and 1990, it did so to a lesser extent among male heads of household who were UI beneficiaries. The poverty rates were less for UI recipients than for nonrecipients. GAO determined that at least 20 percent of this difference was due to such benefits.

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**Decrease in Reciprocity  
Associated With Program's  
Ability to Meet Objectives**

The UI system's ability to help stabilize the economy during recessionary periods, a primary objective of the system, has been lessened since the 1970s. GAO estimates that, had the system paid benefits during the 1990-91

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recession at a rate equivalent to that of the 1974-75 recession (after correcting for inflation and unemployment levels), about \$70 billion would have been pumped into the economy rather than the \$50 billion that was actually paid. Half of the difference was due to a decline in the payment of regular benefits, and half was due to the decrease in extended benefit payments. Similarly, the system's ability to provide temporary wage replacement to the unemployed has diminished.

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## Agency Comments

Labor raised some concern with GAO's overall conclusion that the UI program objectives may be jeopardized and stated that what may be jeopardized is the ability of the UI program, alone, to achieve its objectives. GAO believes that, because of the changing workplace, consideration should be given to whether the program needs to be changed to better meet its objectives. Labor also raised concerns with GAO's study approach and with certain statements in the report. GAO believes that these concerns resulted from a misunderstanding of the study's approach and a misinterpretation of some statements. Therefore, GAO made changes to clarify the report, where appropriate.





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**Abbreviations**

IU/TU	Insured Unemployed/Total Unemployed
UI	Unemployment Insurance



# Introduction

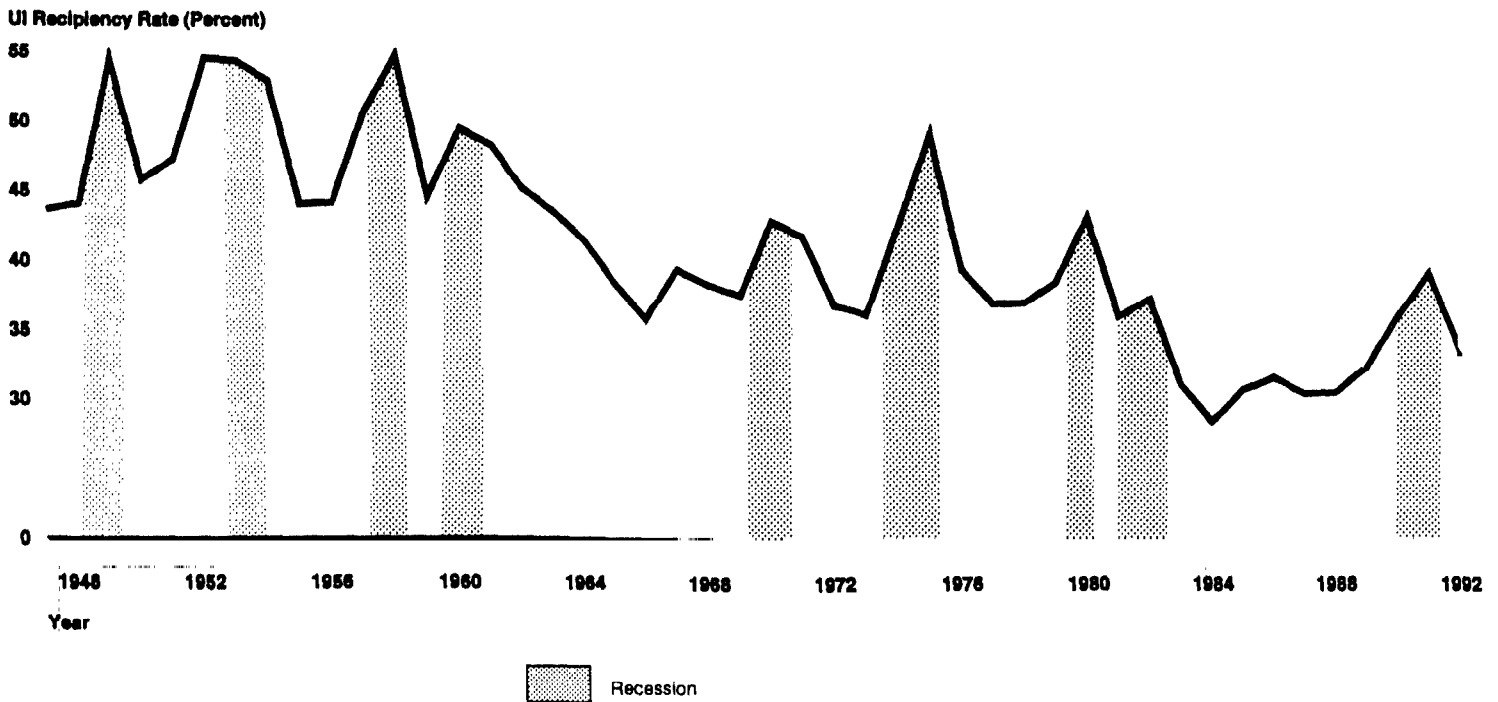
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More than 97 percent of U.S. wage and salary workers are covered under Unemployment Insurance (UI), a system designed to provide short-term income assistance to unemployed workers and to help stabilize the economy during a recession. However, the proportion of unemployed workers who receive UI assistance has been declining, even during recessions when UI reciprocity usually increases. During the 1973-75 recession, up to 50 percent of the unemployed were receiving UI benefits<sup>1</sup> compared with about 39 percent during the recession that began in 1990—one-fifth less (see fig. 1.1). As a result, policymakers are concerned that the UI system may not be providing (1) the income “safety net” intended for those who lose their jobs through no fault of their own or (2) the stabilizing effect on the economy.

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<sup>1</sup>Throughout this report we use the ratio of the number of the insured unemployed to the total number of civilian unemployed, called the IU/TU ratio, to measure the proportion of the unemployed receiving UI benefits. The insured unemployed is the number of recipients of regular UI benefits.

Figure 1.1: Proportion of Unemployed Receiving UI Benefits Has Fallen Since 1950s and Recent 1975 Peak



## Background

The UI system is the federal government's primary means of providing income assistance to unemployed workers. The principal objectives of the program are to (1) temporarily replace a part of unemployed workers' lost wages and (2) help stabilize the economy during a recession by providing the unemployed a part of their lost purchasing power. The UI system pays benefits for a specified period to unemployed workers who have worked long enough and earned sufficient wages to meet their states' minimum eligibility standards. Besides providing the unemployed with regular UI benefits, generally for up to 26 weeks, the UI system also provides them with another 13 weeks of benefits, under an extended benefits program, during long spells of high unemployment.<sup>2</sup>

<sup>2</sup>Extended benefits are paid, by states that meet specific program requirements, to the unemployed who exhaust their regular benefits. Extended benefits are paid at the same rate as regular weekly benefits.

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## Labor Market Perspective for the UI Program

The UI system was created in 1935 to protect workers during temporary periods of unemployment. The expectation was that many of these workers would return to their former jobs in a relatively short period of time. However, because of long-term economic changes, the labor market in which the UI system has been functioning most recently is markedly different from that of the past. Unemployed workers are now without jobs for longer periods of time—often exhausting all their UI benefits—and many are not able to return to their former positions because their jobs have been abolished. During the previous four recessions, 44 percent of the workers who were displaced returned to their former positions, compared to 15 percent who expected to do so following the last recession. One reason for this is the changing workplace. Many industries are reducing the size of their work force while global competition is transferring some jobs to other countries, and improved technology is eliminating others. Many of the new jobs being created are part-time or temporary positions generally paying low wages and offering few or no benefits.

Long-term trends have produced other labor market changes. The proportion of women and younger workers—groups with historically lower eligibility rates for UI benefits—increased from the 1960s through the 1980s. Manufacturing jobs, which traditionally had high UI eligibility rates, have declined, and service occupations, which traditionally had lower eligibility rates, have grown. Geographic shifts in the labor force have occurred, from the northeast and midwest (states with more lenient UI eligibility requirements) to the south and west (states with stricter eligibility requirements).

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## The Federal and State UI Partnership

The UI system operates as a partnership between the states<sup>3</sup> and the federal government. Under this arrangement, the federal government provides broad policy guidance and program direction; the states are responsible for implementing program details.

Within certain limits, states have full autonomy in carrying out their basic program operations. They decide the requirements that unemployed workers must meet for eligibility, the amount of benefits, and the length of time they will pay benefits. They also decide on the tax rates employers must pay on their payrolls. As a result, state eligibility requirements, benefit levels, payroll tax rates, and trust fund balances vary, reflecting

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<sup>3</sup>Fifty-three UI programs cover the 50 states, the District of Columbia, Puerto Rico, and the Virgin Islands. We did not include Puerto Rico and the Virgin Islands in our analysis because some of the data sources we used lacked information about them.



variations in program decisions and the economic fortunes of each state. Because of the states' autonomy, they can, to some extent, control the financial condition of their trust funds by regulating the size of the eligible population, the amount of benefits they pay, and the amount of taxes they collect.

States have established several methods for deciding program eligibility. However, three factors are common to most state eligibility provisions:

- Monetary standards: States specify the minimum levels of recent employment (number of weeks or hours worked) and earnings that the unemployed need to qualify for benefits.
- Availability for work: All state laws require individuals to be available and able to work as a condition for receiving benefits.
- Quit, job offer refusal, or misconduct benefit denials: States may delay or deny benefits to those who quit work without good cause, refuse suitable work, become unemployed because of a labor dispute, or are discharged for misconduct.

Generally, the states compute the amount of weekly UI benefits as a percentage of an individual's average weekly earnings but impose a ceiling on these benefits. Maximum benefits typically vary from between 50 and 70 percent of the state's average weekly wage in UI-covered employment. Most states set the duration of UI benefits by the amount of earnings that an individual has received for a defined period. All but one of the states have established the maximum duration for benefits at 26 weeks.

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## Program Financing

Federal and state payroll taxes on employers finance the UI program. The federal government uses the proceeds from its payroll tax to (1) pay for all program administrative costs and one-half of extended benefit payments<sup>4</sup> and (2) maintain a loan account from which financially troubled states can borrow funds to pay UI benefits. The gross federal tax rate is 6.2 percent on the first \$7,000 paid annually by employers on each employee. If a state meets federal requirements and has no delinquent federal loans, however, its employers are eligible for up to a 5.4-percent credit, making the net federal tax rate 0.8 percent. To receive the maximum federal tax credit, states must, among other things, establish a taxable wage base for state UI taxes at least equal to the federal wage base—currently \$7,000. All states

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<sup>4</sup>Beginning in 1991, additional UI benefits were paid to those who had exhausted their regular benefits. These were paid entirely from federal funds under a separate program, the Emergency Unemployment Compensation Program, enacted in November 1991 and extended in February 1992, July 1992, and March 1993.

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have done this, and, in 1992, 37 states had adopted wage bases above the federal level, ranging from \$7,100 in Connecticut to \$22,700 in Hawaii.

Most of the funds used to pay UI benefits come from the states, which levy a payroll tax on employers to finance regular UI benefits and one-half of extended benefits. States generally structure their UI taxes to include several tax rate schedules. These schedules often vary according to some measure of a state's trust fund balance, with the highest tax schedules generally applying when state fund balances have fallen below a specified level. Within a tax schedule, an employer's tax rates will vary according to the firm's experience in laying off workers who subsequently receive UI benefits, commonly called their experience rating. Those firms with many unemployed workers receiving UI benefits will generally pay a higher UI tax rate. Each state maintains its own trust fund with the U.S. Treasury that is used for depositing program income and paying UI benefits.

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## Forward Funding and State Trust Fund Solvency

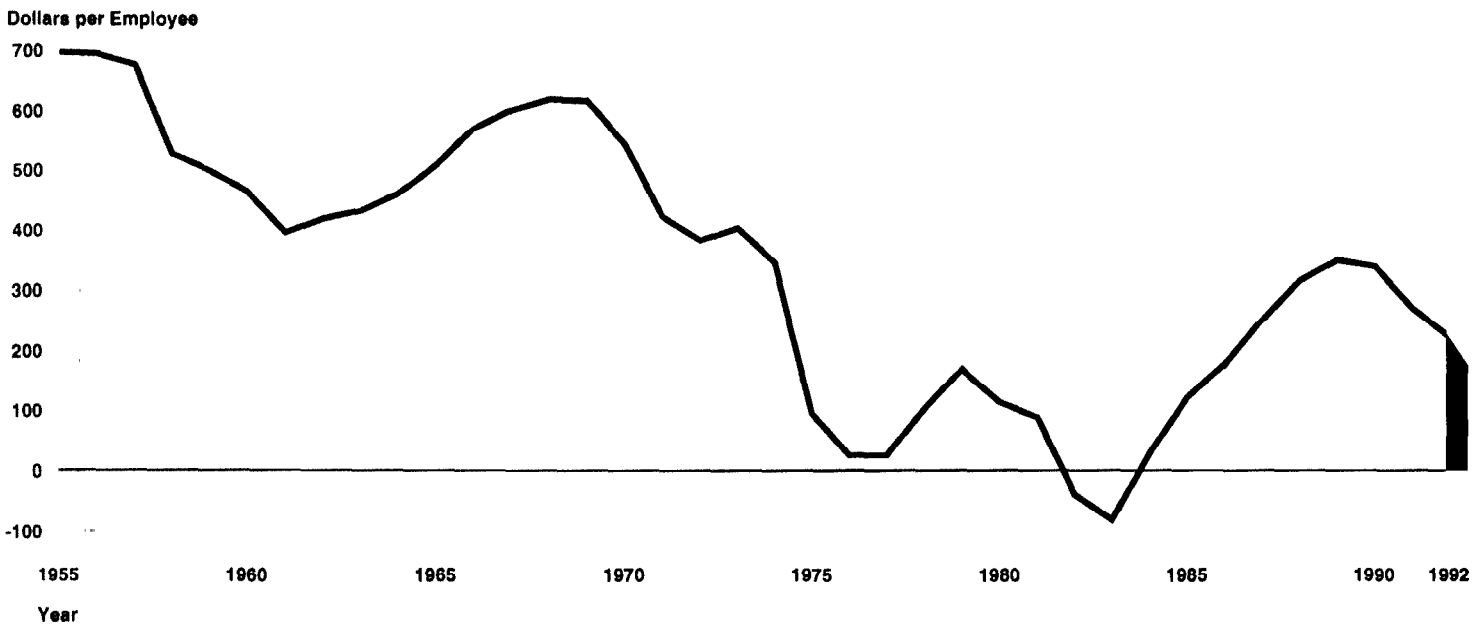
The UI program originally operated as a forward-funded system. Under this approach, tax rates and benefit levels were set so that the program could "save for a rainy day" by building up reserves during periods of economic expansion to be able to pay UI benefits during economic downturns. Because unemployment can vary substantially during a business cycle, it is important that the states build sufficient trust fund reserves to remain solvent during recessionary times. If states encounter financial difficulty and deplete their trust fund accounts, the UI program provides for automatic federal loans so that the states can continue to make UI benefit payments to the unemployed.

The UI program is countercyclical to economic conditions. That is, during economic downturns, program spending increases because many more workers are unemployed and program revenues decrease as payrolls shrink, resulting in a decline in program reserves. Conversely, during periods of economic growth, benefit payments decline and payroll tax revenues increase (assuming employer tax rates are not reduced), resulting in increased program reserves.

The states did a fairly good job of maintaining trust fund reserves during the first three decades of the program. Although a state loan account was established in 1954, the states made little use of the account before the 1970s, with only three state funds ever receiving federal loans and only one fund ever becoming insolvent at the end of a calendar year. Three subsequent recessions, including back-to-back recessions in 1980 and

1981-82, accompanied by large UI benefit payments, reduced or depleted many state trust fund reserves. As a result, many states began to deviate from the forward-funded approach, and reliance on federal loans to sustain UI benefits increased dramatically. For example, during the 1950s and 1960s, the states borrowed less than \$300 million from the federal loan account. During the 1970s, this increased to \$5.6 billion and in the 1980s to \$24.2 billion. State trust funds began to shrink so much that, during the 1980 and 1981-82 recessions, as many as 21 states became insolvent—completely depleting their trust funds—and had to borrow from the federal loan account to pay UI benefits. Figure 1.2 illustrates the condition of the states' UI trust fund over time.

Figure 1.2: Financial Condition of UI System, 1955-1992: Net Reserves in UI System Per Employee



Amount adjusted to 1992 dollars.

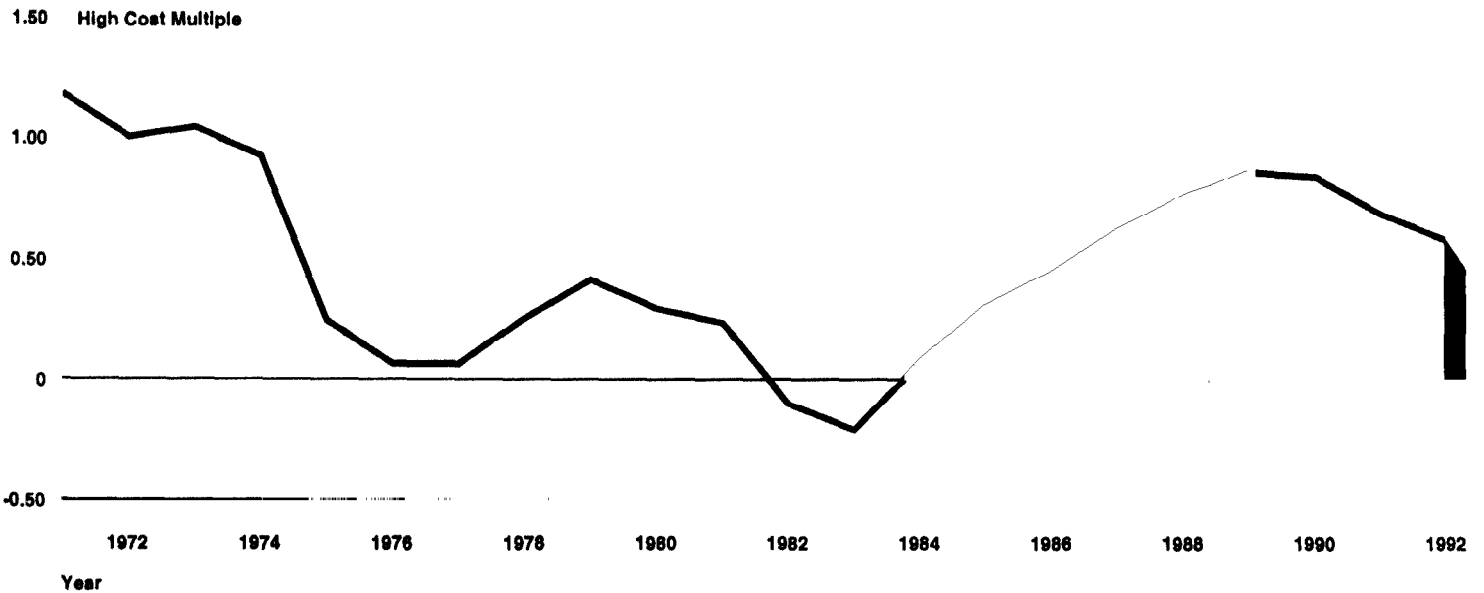
An analysis of one financial indicator of the UI program, the high cost multiple,<sup>6</sup> provides another perspective on the evolution from a forward-funded program toward state reliance on federal loans. The high cost multiple is the most commonly used indicator of how long recession-level benefits could be paid from current state trust fund balances. In the past, the Interstate Conference of Employment Security Agencies has endorsed a high cost multiple standard of 1.5 as indicative of reserve adequacy. This means that trust fund reserves should be sufficient to pay recession-level benefits for 1-1/2 years.

The high cost multiple of the overall UI system (all 51 programs taken together) has declined steadily since the mid-1950s. Between 1954 and 1969, the high cost multiple averaged 2.1, indicating a strong financial position. The cost multiple fell rather steadily during the 1970s and was actually negative in 1982 and 1983 (see fig. 1.3). In 1990, before the recession began, it was 0.84, meaning that, on average, reserves were sufficient to pay about 10 months of recession-level benefits.

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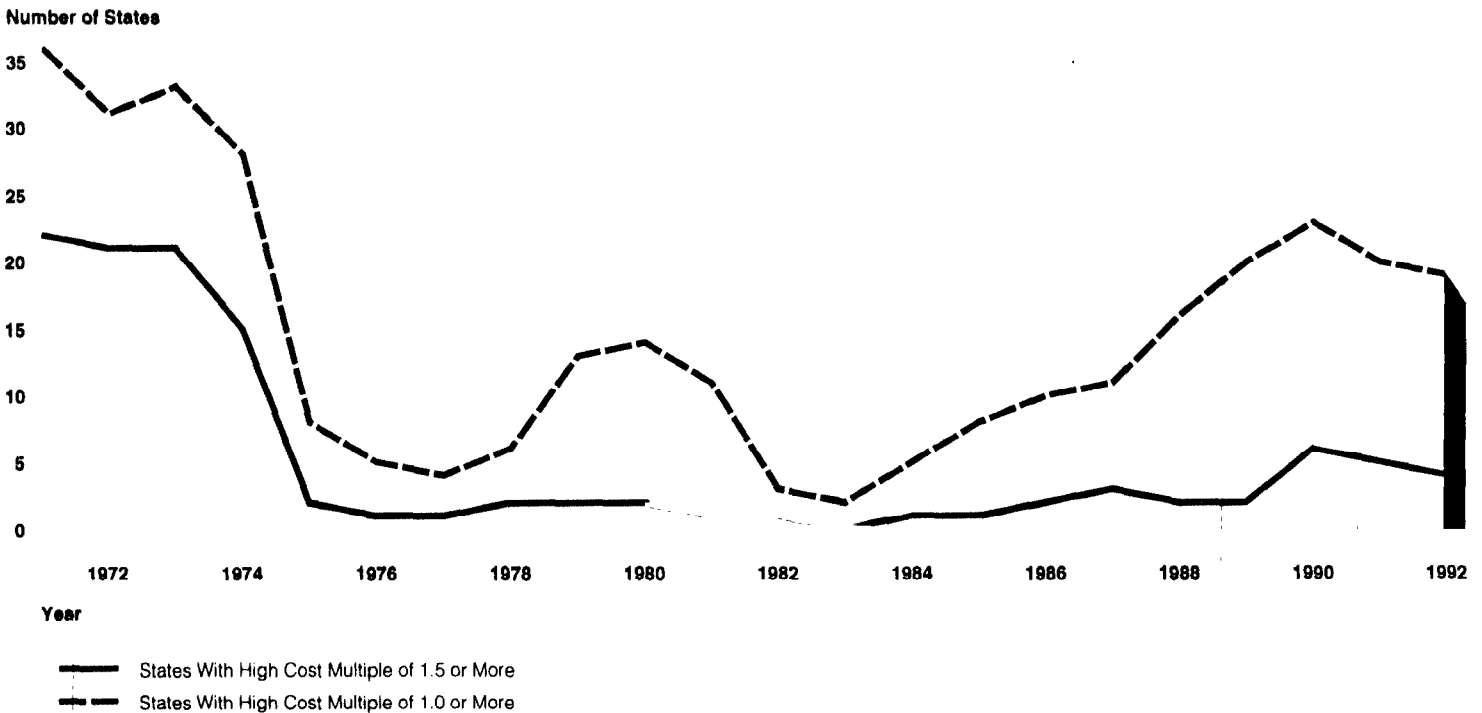
<sup>6</sup>The high cost multiple is calculated by computing two ratios. First, the ratio of current net trust fund reserves to current year total wages earned in insured employment is determined. This is divided by the ratio of the largest amount of total state benefit payments experienced previously in any 12 consecutive months to the total wages in insured employment during those 12 months.

Figure 1.3: High Cost Multiple for the Overall UI System, 1971-1992



As the high cost multiple for the overall UI system has declined, so too has the number of states that maintain adequate trust fund reserves (see fig. 1.4). And the failure to maintain adequate reserves has increased the frequency of state funds' becoming insolvent during periods of high benefit expenditures. In 1955, 49 states had a high cost multiple of 1.5 or higher, and no state was insolvent at the end of the year. Although the number of states maintaining similar high cost multiples varied during the next 15 years, at least half were at or above the 1.5 level and few, if any, experienced insolvency. Between 1970 and 1983, the number of states at the 1.5 level steadily declined to none in 1983 and, at the same time, 21 states were insolvent. In 1990, before the recession began, 6 of the 51 UI programs had a high cost multiple at or above the 1.5 standard, compared with 33 states in 1970 (a similar point in the business cycle). Using a less stringent standard of 1.0 would add an additional 17 states to the list of those with sufficient reserves in 1990. In contrast, virtually all state trust funds surpassed the 1.0 standard in 1970.

Figure 1.4: States With Adequate Reserves as Measured by the High Cost Multiple



Several factors have caused the decline in reserve adequacy and the growth in trust fund insolvency. These include the high unemployment rates generated by three recessions during the last 20 years and increases in benefit expenditures resulting from the creation of the extended benefits program; states had to fund half of the extended benefits.<sup>6</sup>

In addition, regional competition for new investment and jobs may be encouraging states to keep UI taxes as low as possible to improve a state's general business climate. During prosperous times, states may experience greater pressures to reduce employers' UI taxes without cutting benefits. Thus, adequate reserves are not accumulated, even when loans are paid off and the economy is expanding.

<sup>6</sup>The extended benefits program was authorized in 1970. Between 1974 and 1982 (the period that includes the three recessions), the states paid more than \$12 billion in extended benefits.

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## Federal Response to State Trust Fund Insolvency

The Congress enacted several laws in the early 1980s designed to move the system toward a positive reserve balance. These changes, in essence, made it more expensive for states to deplete their trust fund accounts and borrow from the federal government.

During the 1970s and early 1980s, states could obtain federal loans to continue paying UI benefits at little, if any, cost. Federal loans to the states during that time were interest free. However, the states were required to repay their loans within a specified time or have a so-called "penalty tax" assessed against employers in their states—that is, a reduction in the federal tax credit. However, because of large UI benefit expenditures caused by high unemployment, the Congress enacted legislation permitting states, between 1975 and 1979, to delay loan repayments without liability for penalty taxes if they met certain tax structure criteria or repaid a portion of the loan.

Interest-free loans and deferred penalty taxes, coupled with the financial difficulties of many state trust funds, resulted in slow repayment of federal loans. Furthermore, heavy state borrowing from the mid-1970s and early 1980s exhausted the federal loan account, requiring it to obtain general revenue transfers of more than \$14 billion.

The Congress permitted the legislation authorizing the delay in loan repayments to expire in 1980. In addition, it enacted legislation in 1981 that required states to pay interest on all loans after March 31, 1982, if the states did not repay the loan during the same fiscal year as borrowed. These changes provided strong incentives for insolvent state trust funds to expedite loan repayments. Repayments grew from \$362 million in fiscal year 1982 to almost \$2.6 billion in fiscal year 1983, a sevenfold increase. During fiscal years 1983-85, state trust funds repaid more than \$16.0 billion in federal loans.

In 1983, the Congress provided the states with additional financial incentives to regain trust fund solvency. It allowed states that made progress toward restoring trust fund solvency to receive deferrals on federal loan interest and discounted federal loan interest rates and permitted partial freezes on federal UI tax credit reductions on employers. To qualify for many of these incentives, states were required to amend their UI laws to improve program solvency by both raising UI taxes and reducing benefit costs.

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## State Reaction to Federal Changes

For the most part, the states reacted to federal UI policy changes by increasing UI taxes and reducing benefits, program modifications that, to an extent, improved the financial status of their trust funds. One reaction to federal changes available to the states was to improve the financial status of their UI programs by increasing program revenues. Many took this course either by increasing their state UI taxable wage base (the portion of an employee's wages subject to state UI taxes) or by establishing an employer tax rate structure that varies according to some measure of the state trust fund's balance. Under the latter arrangement, the highest taxes would be applicable when state fund balances fell below a specified level. Between 1978 and 1990, 40 states either increased their taxable wage base, modified their tax rate structure, or both.

The states took additional actions in response to federal changes. Some states reduced the maximum length of time the unemployed could receive benefits. Between 1980 and 1987, seven of the nine states with a maximum benefit duration longer than 26 weeks reduced this time to 26 weeks, the limit most state programs place on the length of benefit receipt. In addition, during the 1980s, states made it more difficult for the unemployed to qualify for benefits. From 1978 to 1990, eight states increased the earnings level required to be eligible for the minimum weekly benefit amount, and seven changed their earnings distribution formula so that the number of unemployed workers eligible for benefits decreased.

States also increased disqualification penalties. All states disqualify applicants from receiving UI benefits if they quit their jobs without a sufficient reason, were fired for misconduct, or refused to accept suitable employment. Disqualification for one of these reasons may result in a postponement of benefits, a reduction in benefit payments, or the cancellation of benefit rights. Between 1978 and 1990, 20 states increased the penalties for one or more of these three reasons.

Overall, between 1978 and 1990, 37 states either reduced the maximum number of weeks the unemployed could receive UI benefits, raised their minimum earnings requirement by more than 10 percent (after adjusting for inflation), or increased one or more disqualification penalties.

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## Effect of State Reaction on Reciprocity Rates

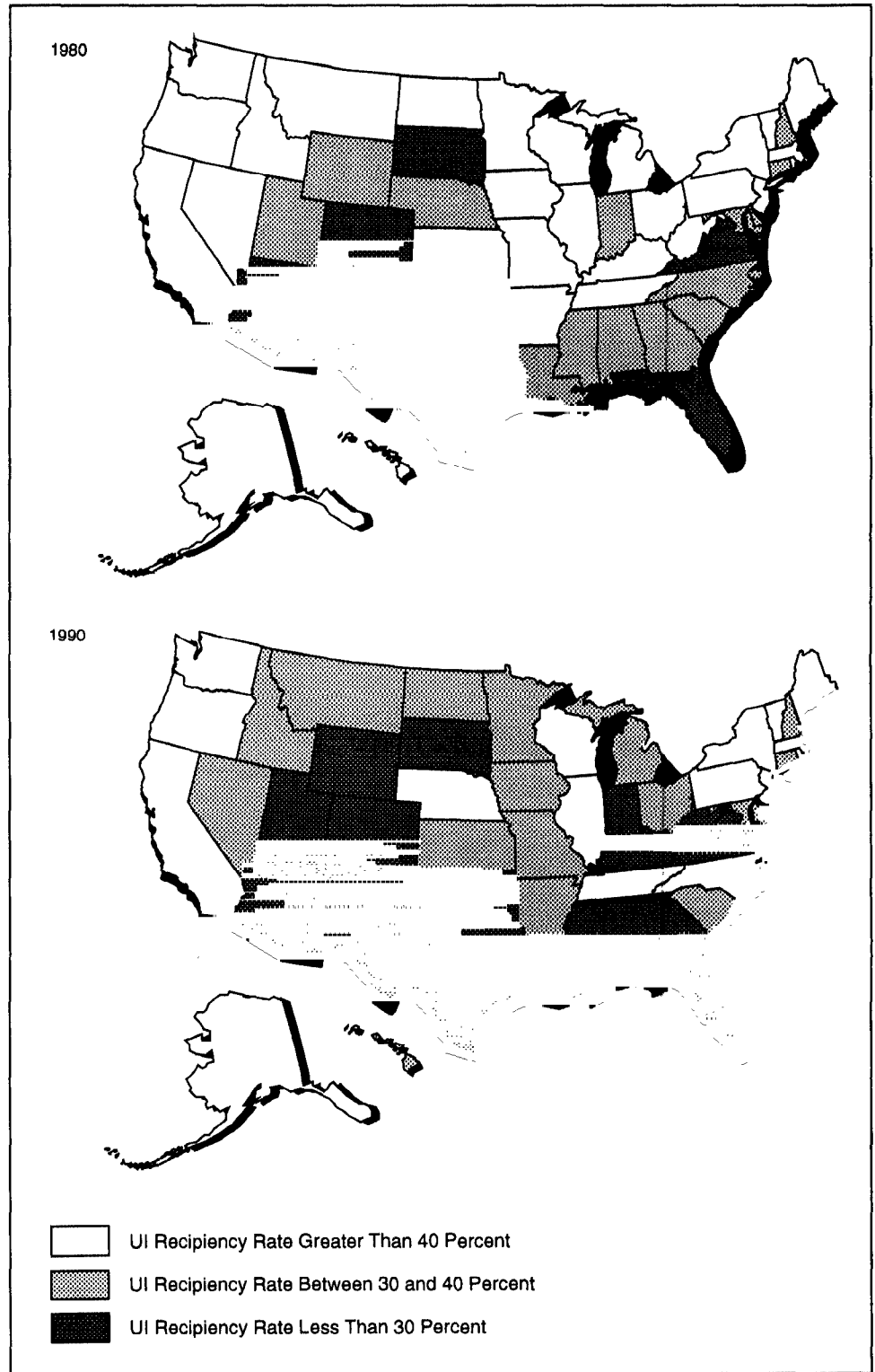
Although state reactions achieved the desired effect of improving trust fund solvency, they also reduced the proportion of the unemployed receiving UI benefits in the early 1980s. By 1984, following back-to-back



recessions in 1980 and 1981-82, the proportion of unemployed workers receiving benefits had declined to 29 percent, substantially lower than in the most recent peak recession (1975), in which the highest proportion was 50 percent. The percentage of unemployed workers receiving benefits rose slowly in subsequent years and reached 39 percent in the 1990-91 recession.

The extent to which the unemployed obtained UI benefits dropped in nearly every state between 1980 and 1984. While nine states had rates over 50 percent in 1980, no state's reciprocity rate exceeded 50 percent in 1984. In six states, more than 40 percent of the unemployed got UI benefits in 1984, but in more than half the states less than 30 percent did. Although the proportion of the unemployed receiving benefits increased somewhat by 1990—to 36 percent nationwide—it was considerably below the 1980 level. As shown in figure 1.5, in 1990, 18 states were providing benefits to less than 30 percent of their unemployed workers compared with 8 states in 1980. UI reciprocity rates for individual states, in selected years, appear in appendix I.

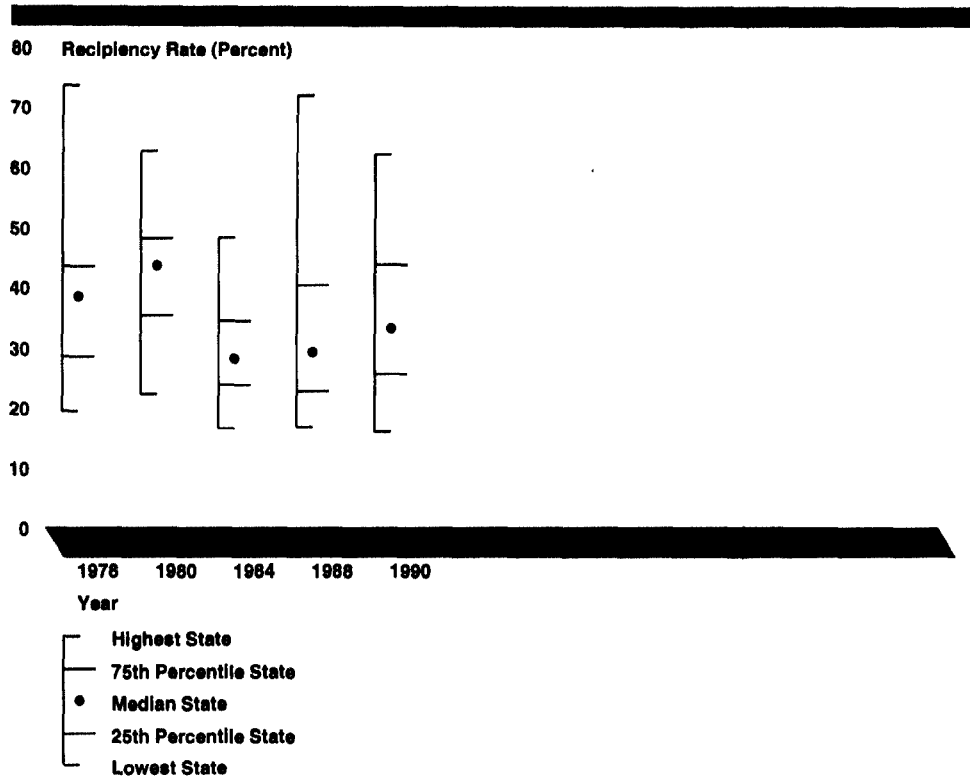
Figure 1.5: UI Reciprocity Rates by State, 1980 and 1990



The change in the percentage of unemployed people getting UI benefits varied from state to state. For example, 13 states had a decrease in UI reciprocity rates of more than 40 percent between 1980-84, including 4 with a decrease of more than 50 percent. On the other hand, two states had slight increases in their reciprocity rates. Although state UI reciprocity rates fluctuated, the relative rankings by reciprocity rate of individual states remained similar. That is, states whose reciprocity rates were higher than others' retained high rankings regardless of whether overall reciprocity rates increased or decreased. Six of the 10 states with the highest percentage of unemployed workers getting benefits in 1980 ranked in the top 10 in 1984 and 1990. Similarly, 5 of the 10 states with the lowest reciprocity rates in 1980 ranked in the bottom 10 in 1984 and 1990.

The percentage of unemployed workers collecting UI benefits in 1990 was 36 percent nationwide, but the rates continued to vary widely among states—ranging from 20 percent or lower in four states (Florida, Oklahoma, South Dakota, and Virginia), to over 55 percent in three states (Alaska, Massachusetts, and Rhode Island). Figure 1.6 provides additional details on state UI reciprocity rates.

Figure 1.6: UI Reciprocity Rate Shows Wide Variation Among States



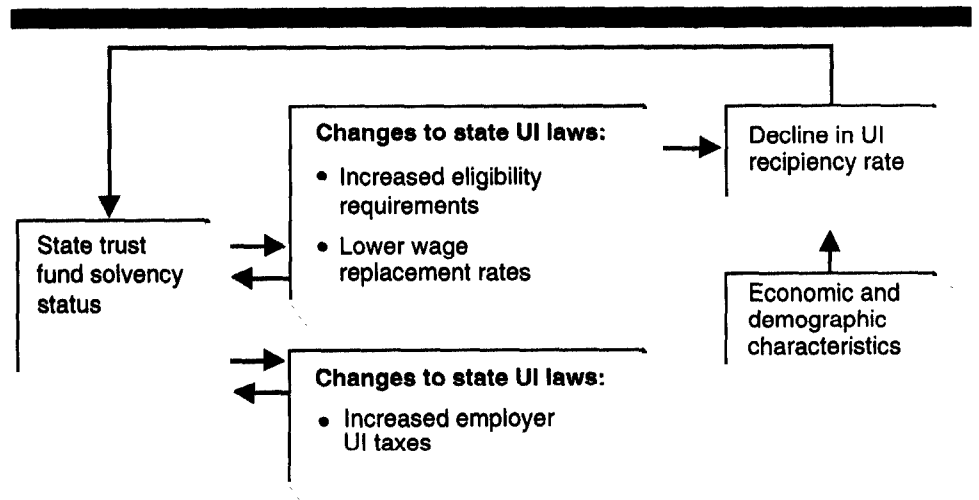
## Objectives, Scope, and Methodology

The Chairman of the Senate Committee on Finance asked us to determine the factors contributing to the decline in the proportion of the unemployed workers receiving benefits under the UI system. He also requested that we determine the effect of the decline on the ability of the program to meet its objectives of partially replacing the wages of the unemployed and acting as an economic stabilizer during recessions.

We estimated the factors contributing to the decline in unemployed workers' receiving regular UI benefits between the late 1970s and 1990. Although previous studies have been done in this area, for the most part they concentrated on the extent to which changes in the demographics of the unemployed and the laws controlling eligibility and benefit levels

affected UI reciprocity.<sup>7</sup> Our earlier work<sup>8</sup> and discussions with our consultant,<sup>9</sup> coupled with previous research, indicated that the causes of the decline in UI reciprocity rates were multiple and interrelated. We developed a simultaneous equation regression model that extends previous analyses and demonstrates the complex interaction among UI reciprocity rates; the financial condition of state trust fund balances; UI laws related to employer tax rates, benefit levels, and eligibility requirements; and the demographics of the unemployed population (fig. 1.7). We analyzed data from the 50 states and the District of Columbia, covering a 13-year period (1978 through 1990). We used UI program data from Department of Labor reports in conducting our analysis. Appendix II contains a detailed description of our approach and methodology.

Figure 1.7: GAO's Regression Model



We also visited seven states to corroborate the results from our model. We judgmentally selected the states—California, Colorado, Florida, Kentucky, Massachusetts, Michigan, and New Hampshire—to reflect differing patterns of change in the insured unemployed (includes those receiving regular state UI program benefits but not those receiving extended

<sup>7</sup>See bibliography.

<sup>8</sup>Unemployment Insurance: Adequacy of State Trust Fund Reserves (GAO/T-HRD-91-7, Feb. 20, 1991); Unemployment Insurance: Trust Fund Reserves Inadequate to Meet Recession Needs (GAO/HRD-90-124, May 31, 1990); Unemployment Insurance: Comments on HR. 3896, The Unemployment Compensation Reform Act of 1990 (GAO/T-HRD-90-15, Feb. 22, 1990); and Unemployment Insurance: Trust Fund Reserves Inadequate (GAO/HRD-88-55, Sept. 26, 1988).

<sup>9</sup>Dr. Wayne Vroman, Senior Research Analyst, Urban Institute.

benefits) to total unemployed ratio and the solvency status of their UI trust fund accounts and to provide geographic dispersion. At each location, we interviewed responsible state UI officials to obtain information and views on factors contributing to the decline in the proportion of the unemployed receiving UI benefits. We also reviewed states' analyses on the effect that various initiatives and changes had on reciprocity rates. Table 1.1 provides a brief profile of the states we visited.

**Table 1.1: Conditions of UI Programs at Seven States Visited**

State	Solvency status, 1978-1990	IU/TU ratio mid-1991 (percent)	High cost multiple mid-1991
California	Solvent	44.0	0.72
Colorado	Insolvent 1982-84	32.5	0.91
Florida	Solvent	24.7	1.11
Kentucky	Insolvent 1981-84	24.8	0.61
Massachusetts	Insolvent 1978	41.7	0.0
Michigan	Insolvent 1978-86	29.4	0.12
New Hampshire	Solvent	31.2	0.61

To determine the effect of a decline in the proportion of the unemployed who receive UI benefits on the program's ability to stabilize the economy, we did comparative analyses of the amount of benefits paid in prior years compared with that paid in 1990. In conducting this analysis, we divided the actual UI benefits paid in each year (from 1968 to 1990), adjusted to the 1990 price level, by the number of unemployed people in that year. This provided the average benefits paid per unemployed person each year in 1990 dollars. We then multiplied these yearly amounts by the 1990 unemployment level. This calculation yielded a hypothetical amount of UI benefits that would have been injected into the economy in 1990 under the UI system in effect each year before 1990. In addition, for each year we multiplied the UI reciprocity rate by the wage replacement rate. This provided another measure of the funds the UI system has injected into the economy each year and the percent of wages replaced for all unemployed workers.

To examine the program's ability to provide temporary wage replacement to the unemployed, we analyzed the average annual UI wage replacement rates from 1968 to 1990 for each state as well as programwide.

In analyzing the characteristics of UI recipients, as well as the poverty status of recipients and nonrecipients of UI benefits, we used the

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**March 1981 and March 1991 supplements to the Current Population Survey.**

We did our work from January 1992 to November 1992 in accordance with generally accepted government auditing standards.

# Trust Fund Solvency Is Key to UI Reciprocity Rate

The decline in the proportion of the unemployed population who received UI benefits is associated with the deteriorating financial condition of states' UI trust funds. All other things being equal, states with lower UI trust fund balances attempted to improve their financial condition by enacting more stringent UI laws, such as tightening eligibility requirements and lowering the proportion of wages replaced by UI benefits. These changes, while improving UI trust fund solvency, led to a lower proportion of unemployed persons receiving UI benefits. On the other hand, states with higher UI trust fund balances had smaller decreases in the percentage of the unemployed provided benefits. Factors such as economic conditions and demographic characteristics and employers circumventing UI laws also contributed to the decline in UI reciprocity.

## Declining Trust Fund Solvency Levels Contributed to Lower UI Reciprocity Rates

Deteriorating trust fund solvency status was associated with a decline in the proportion of the unemployed who received UI benefits. Although state trust fund solvency was not directly related to UI reciprocity, it ultimately affected the proportion of the unemployed who received UI benefits through multiple and interrelated factors. Our analysis demonstrated a complex relationship in which trust fund status was associated with changes in UI laws affecting UI benefit eligibility and wage replacement rate. These law changes, in turn, were related to changes in UI reciprocity rates. Appendix II contains details of our analysis.

Our discussions with UI officials in seven states—California, Colorado, Florida, Kentucky, Massachusetts, Michigan, and New Hampshire—confirmed the relationship among trust fund status, UI law changes, and reciprocity.

Our analysis of state high cost multiple (hereafter referred to as cost multiple) levels during the 1980s confirms the association of trust fund solvency status with the proportion of unemployed workers who receive UI benefits. States with low cost multiples in 1980 had the biggest declines in the proportion of unemployed who received UI benefits in the years immediately after 1980. The 10 states with the lowest cost multiples in 1980—averaging about -0.5 on average—saw their proportion of unemployed receiving UI fall by about 13 percentage points or 28 percent in the next 5 years. On the other hand, the 10 states with the highest cost multiples in 1980—with an average over 1.0—experienced an average



decline of 7 percentage points or 18 percent during the same period (see table 2.1).<sup>10</sup>

**Table 2.1: States With Lower Cost Multiples in 1980 Experienced Largest Drop in UI Reciprocity Rates**

Quintile (ranked by cost multiple in 1980)	Average cost multiple in 1980	Average decline in UI reciprocity rate, 1980 to 1985 (percentage points)	Average decline in UI reciprocity rates, 1980 to 1985 (percent)
Lowest 10 states	-0.49	-13	-28
Next lowest 10 states	0.11	-11	-26
Middle 11 states	0.52	-11	-28
Next highest 10 states	0.92	-7	-18
Highest 10 states	1.27	-7	-18

### Declining Trust Fund Solvency Associated With State UI Law Changes

The states implemented changes to their UI programs to improve the financial status of their trust funds. These actions were associated with federal law changes that made it more expensive for the states to deplete their trust fund balances and borrow federal funds. The state program changes were aimed at cutting UI program outlays and increasing revenue and, for the most part, consisted of reducing the amount of UI benefits paid, tightening program eligibility requirements, and increasing employer UI taxes.

Our analysis demonstrated the association between trust fund solvency changes and changes to state UI laws, which is discussed in detail in the following sections. In addition, UI officials in five of the seven states we visited confirmed that the adequacy of their trust fund was a driving factor in the changes to their UI programs. Although the other two states did not relate their changes to trust fund balances, they too implemented changes that coincided with declining trust fund balances and trust fund insolvency. The seven states made most of the changes in the early 1980s, shortly after many state trust funds declined or became insolvent. Figure 2.1 summarizes the legislative changes these states made between 1978 and 1992.

<sup>10</sup>We ranked the states according to the value of their cost multiple in 1980. We then looked at the lowest one-fifth, or quintile, of the values and averaged the cost multiple and other data within the 10 states. We did the same for the next lowest one-fifth of the states and for the remaining three quintiles. Because we included the District of Columbia in our analysis, the middle quintile contains 11 states.

Figure 2.1: Legislative Changes Implemented by the States Between 1978 and 1992

	CA	CO	FL	KY	MA	MI	NH
<b>Eligibility requirements</b>							
Increased qualifying wage requirement	●			●	●	●	●
Increased length of work requirement	●					●	
<b>Disqualification provisions</b>							
Disqualification provisions strengthened		●	●	●		●	●
<b>Benefit levels</b>							
Decreased level of minimum benefits <sup>a</sup>	●	●	●	●	●		●
Decreased level of maximum benefits <sup>a</sup>	●	●		●			●
Decreased maximum duration of benefits					●		●
<b>UI taxes</b>							
Increased employer tax rates	●	●	●	●	●	●	●
Increased taxable wage base (above federal minimum)		●		●	●	●	

<sup>a</sup>Reflects comparison of 1978 and 1990 weekly benefit amounts adjusted to 1990 constant dollars.

### Changes in UI Benefit Amounts

According to our analysis, states with trust funds approaching insolvency, on average, pay lower benefits than other states, which was confirmed during our state visits. Using the states' high cost multiple as a measure of solvency, we found that UI benefits paid in states with declining cost multiples replaced a lesser amount of the wages individuals lost through unemployment than other states. For example, Kentucky had a cost multiple of about 0.6 in 1978, but it declined to about -0.4 in 1984. From 1979 to 1984, the state's wage replacement rate decreased from about 40 percent to about 32 percent. Conversely, those states whose cost multiples increased over time generally experienced an increase in the wage replacement rate. For example, Florida's cost multiple was about 1.0 or higher from 1979 to 1990, and its wage replacement rate gradually increased from about 31 to 37 percent during that period.

The states we visited also limited the amount of benefits they paid out to the unemployed by allowing the value of benefits (in inflation-adjusted dollars) to decline or by lowering the length of time UI benefits were paid. We found that, in six of the seven states visited, the minimum weekly benefit amount (after adjusting for inflation) declined between 1978 and 1990 (see table 2.2). In two states, the actual dollar amount was not increased at all, resulting in a 50-percent decrease after adjusting for inflation. In four other states, the dollar amount was increased but not enough to keep up with inflation. In one state, Michigan, the minimum

weekly benefit amount increased substantially, even after adjusting for inflation.

**Table 2.2: Minimum Weekly Benefit Amounts Did Not Keep Up With Inflation**

State	Minimum weekly benefit amount (dollars)			Percent change	
	1978, actual	1978, adjusted for inflation <sup>a</sup>	1990, actual	Actual	Inflation-adjusted
Colorado	25	50	25	0	-50
Florida	10	20	10	0	-50
Massachusetts	12	24	14	17	-42
California	30	60	40	34	-33
New Hampshire	21	42	35	67	-17
Kentucky	12	24	22	84	-8
Michigan	16	32	59	270	84

<sup>a</sup>Adjusted to 1990 dollars.

Four of the seven states also lowered their maximum weekly benefit amount, after adjusting for inflation, with reductions of up to 21 percent (see table 2.3). In addition, two of the states we visited froze their maximum weekly benefit amount for a time during 1978 to 1990—Kentucky for about 6 years and Michigan for about 5 years—as part of their overall plan to address trust fund insolvency.

**Table 2.3: Maximum Weekly Benefit Amounts Generally Declined Slightly**

State	Maximum weekly benefit amount (dollars)			Percent change	
	1978, actual	1978, adjusted for inflation <sup>a</sup>	1990, actual	Actual	Inflation-adjusted
New Hampshire	102	204	162	59	-21
California	104	208	190	83	-9
Colorado	122	244	224	84	-8
Kentucky	94	188	186	98	-1
Michigan	136	273	275	102	1
Massachusetts	115	230	272	137	18
Florida	82	164	200	144	22

<sup>a</sup>Adjusted to 1990 dollars.

Six of the seven states provided regular UI benefits to unemployed workers for a maximum of 26 weeks; Massachusetts, however, provided the

unemployed with benefits for up to 30 weeks. In response to an insolvent trust fund, in 1992 Massachusetts decreased the maximum benefit period to 26 weeks. According to state officials, the change is expected to decrease benefit outlays by approximately \$60 million annually.

## Changes to Eligibility Requirements

We found that states with declining cost multiples tightened their UI program eligibility requirements to reduce the number of unemployed individuals eligible for benefits and thus reduce program expenditures. Our analysis showed that states with declining cost multiples increased the minimum amount of wages an unemployed person would have to earn to become eligible. However, the states did not implement this change immediately following a year of declining trust fund solvency.

Between 1978 and 1992, the seven states we visited legislated stricter eligibility requirements to limit access to benefits. Actions that made it more difficult to qualify for UI benefits included increasing the length of work required for eligibility; raising the qualifying wage requirements; or increasing the penalties for claimants who voluntarily quit a job, were terminated due to misconduct, or refused suitable employment. Five of the seven states we visited modified their qualifying wage requirements between 1978 and 1992 to make it more difficult for claimants to qualify for benefits. For example, Michigan's wage requirement in 1978 was 14 weeks of work at \$25 or more a week, but in 1983 this was increased to 20 weeks of work at \$100.50 per week—more than doubling its earnings requirement after adjusting for inflation. New Hampshire increased its qualifying wage requirement six times between 1978 and 1992, raising the minimum amount that must be earned in each of two quarters by an inflation-adjusted 100 percent.

Several state officials we met with attributed the decline in the number of claimants receiving benefits, in part, to changes in disqualification provisions. Individuals who quit their jobs without good cause, are terminated due to misconduct, or refuse suitable work generally are disqualified from receiving UI benefits. Between 1978 and 1992, five of the seven states increased their disqualification provisions for workers who were terminated for misconduct or quit their employment voluntarily. Each state effected more stringent disqualification requirements, making it more difficult for such workers to regain access to UI benefits. For example, Florida increased the requalifying wage requirement by 70 percent. Disqualified claimants in 1978 were ineligible to receive benefits for the duration of their unemployment and until they regained employment and earned wages equal to 10 times what would have been

their weekly benefit amount. In 1974, the disqualification penalty had been increased to 17 times claimants' weekly benefit amount.

Kentucky also implemented legislative changes since 1978 that increased penalties for disqualified claimants. In 1978, claimants who quit voluntarily were disqualified for the duration of their unemployment and until they regained employment and earned wages equal to what would have been six times their weekly benefit amount. Claimants who were terminated due to misconduct were disqualified for a period ranging from 6 to 16 weeks. As of 1984, claimants separated from work for either reason were disqualified for the duration of their unemployment and until they regained employment for 10 weeks (up from 6 weeks) with earnings equal to at least 10 times what would have been their weekly benefit amount.

To decrease UI costs, Colorado eliminated a provision in its UI program that had allowed eligibility to claimants if they quit work for a better job but were subsequently laid off. State officials had conducted an analysis showing that repealing this provision would reduce benefit outlays by about 5 percent.

#### Changes to Employer UI Taxes

We also found that decreasing solvency levels were associated with UI law changes affecting state employer UI tax rates. Our analysis showed that states with declining cost multiples tended to increase employer UI tax rates in subsequent years.

We noted comparable trends in the states we visited. For example, Colorado's cost multiple fell from about 0.9 to -0.5 from 1979 to 1983. Effective employer UI tax rates increased at about the same time, from about 0.4 percent in 1980 to about 1.3 percent in 1984. Similarly, California's cost multiple fell from 1.08 to 0.6 from 1980 to 1983 while its effective employer tax rate rose from 1.0 percent to 1.24 percent during 1981 to 1984. As its cost multiple rose steadily back to about 0.9 in 1989, California's effective tax rate decreased steadily to 0.6 by 1990.

Officials in the seven states we visited confirmed that they made changes to their employer tax structure because of solvency concerns. For example, effective in 1982, Kentucky implemented a self-correcting employer tax rate system, which, according to state officials, ensures the solvency of the UI trust fund. Under this system, employer contribution rates and UI claimant benefit amounts are tied directly to the state trust fund balance. Basically, as trust fund balances increase, employer contribution rates decrease and claimant benefit rates increase. The

opposite is true as the trust fund balance decreases. Such a system is meant to deter fund depletion when high unemployment exhausts the trust fund and allows both employers and claimants to fare better when the fund is adequate.

As of January 1992, five of the states we visited had multiple tax schedules, while the remaining two had a single tax schedule. Generally, in states with multiple tax schedules, the schedule in effect for a given year is determined by the state's trust fund balance. When the state trust fund balance is low, a schedule containing relatively higher rates is usually in effect. Conversely, when the balance is high, a schedule with lower rates is in effect.

In addition to increasing their tax rate schedules between 1978 and 1992, four of the seven states increased their taxable wage base over the minimum federal taxable wage base. Currently, the UI program requires the states to assess UI taxes on the first \$7,000 of wages earned by employees to receive the maximum federal tax credit. Four increases in Michigan's taxable wage base, between 1982 and 1992, have increased the state's taxable wage base to \$9,500. Colorado's taxable wage base was increased to \$10,000 in 1988, and Kentucky's was increased to \$8,000 in 1982.

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**Analysis of State Cost  
Multiples Confirms  
Influence of Solvency on  
Law Changes**

Our analysis of state high cost multiples during the 1980s indicated that the cost multiple level was associated with changes to UI laws affecting eligibility and employer taxes. The states that experienced the greatest decreases in their cost multiples changed their UI laws the most. The 10 states with the largest declines between 1980 and 1983—an average of over 1.0—saw an effective employer tax rate increase of about 0.9 percentage points and an increase in the minimum earnings requirement of over \$800 between 1980 and 1984. States with the smallest cost multiple decreases—which on average slightly increased their cost multiples—had little change in their effective tax rates and their minimum earnings requirement (see table 2.4). The latter states were also those with the smallest decline in the percentage of unemployed persons receiving benefits from 1980 to 1984.

Table 2.4: States With Largest Declines in Cost Multiples Changed UI Laws the Most

Quintile (ranked by change in cost multiple from 1980 to 1983)	Change from 1980 to 1983	Change from 1980 to 1984		Change from 1980 to 1985	
	Cost multiple	Effective tax rate (percentage points)	Minimum earnings requirement (1990 dollars)	Proportion of unemployed receiving benefits (percentage points)	Proportion of unemployed receiving benefits (percent)
Lowest 10 states	-1.17	+0.87	+811	-11	-24
Next lowest 10 states	-0.69	+0.41	+350	-10	-21
Middle 11 states	-0.43	+0.30	+179	-12	-29
Next highest 10 states	-0.17	+0.25	+185	-11	-30
Highest 10 states	+0.18	+0.04	-5	-6	-14

### UI Law Changes Related to Reciprocity Rates

We found that UI law changes affecting the wage replacement rate and the minimum earnings requirement directly affect reciprocity. An increasing proportion of the unemployed tended to receive UI benefits in states with increasing wage replacement rates, but a decreasing proportion got benefits in those with decreasing replacement rates. All else being equal, a 10-percentage point higher wage replacement rate was associated with a 4-percentage point higher UI reciprocity rate.

A relationship also existed between the minimum earnings requirements for eligibility and UI reciprocity. States with a higher minimum earnings requirement tended to provide benefits to a smaller proportion of unemployed workers, whereas those with a lower minimum earnings requirement tended to give benefits to a higher proportion. For example, an increase of \$1,000 in the earnings requirement was, all else remaining equal, associated with a 5-percentage point reduction in UI reciprocity.

A Michigan analysis showed that an additional 11 percent of the unemployed would have received UI benefits each year if the less restrictive eligibility criteria of 1978 had been in effect from 1988 to 1990 (see table 2.5). Michigan analyzed the impact on unemployed workers of increasing its work experience requirement from 14 weeks to 18 weeks in 1981 and then to 20 weeks in 1983.

**Table 2.5: Comparison of Number of UI Claimants in Michigan Under 1988 Work Experience Requirements Versus 1978 Requirements**

Year	Claimants based on 1988 requirements (20 weeks)	Claimants based on 1978 requirements (14 weeks)	Percent increase under less restrictive requirements
1988	368,300	408,600	10.9
1989	390,800	433,900	11.0
1990	419,500	464,900	10.8

### Other Factors Contributed to the Decline in UI Reciprocity Rates

Some economic and demographic factors included in our analysis were also significant determinants of UI reciprocity. A high proportion of long-term unemployed in a state's unemployed population was associated with a reduction in the percentage of unemployed workers getting benefits. A high proportion of workers who lost their jobs, on the other hand, was associated with an increase in the unemployed receiving benefits. In addition, officials in six of the seven states we visited identified other factors that influenced the number of unemployed eligible for UI benefits and contributed to the decline in UI reciprocity. These factors included employers circumventing UI laws, independent contractor and consultant misclassification, employee leasing, and structural changes in the work force.

### Economic and Demographic Factors Affect UI Reciprocity

High proportions of long-term unemployed reduce UI reciprocity rates because many of the long-term unemployed no longer receive benefits because they have received the maximum amount of UI benefits. In contrast, those who lose their jobs through no fault of their own are those most likely to apply for and receive benefits; so, as their share of the unemployed grows, so does the reciprocity rate. Our statistical analysis suggested that the proportion of the unemployed who were long-term unemployed or who lost their jobs had a significant effect on UI reciprocity. Among all unemployed, a 10-percentage point increase in long-term unemployed individuals was associated with about a 5-percentage point reduction in the proportion of those receiving benefits. On the other hand, a 10-percentage point increase in those who lost their jobs was associated with about a 1.5-percentage point increase in UI beneficiaries.

### Employers Circumvent UI Eligibility Laws.

Some employers seek to minimize the UI taxes they must pay by carefully managing employees' hours and wages so that, if they become unemployed, the employees will not be eligible for benefits and thus not affect the employers' UI tax rate. State officials in two states we visited



reported that employers' manipulation of the UI system has contributed to the long-term decline in the proportion of unemployed receiving UI benefits. Some employers, many of whom rely on consulting firms that specialize in UI matters, control their employees' work schedules and earnings to ensure that these employees do not meet the minimum qualifying wage requirement or the credit week requirement. Moreover, officials in Michigan explained that UI laws have even begun to act as a barrier and disincentive to employment. The high tax structure necessitated by high UI costs motivates employers to scheme to keep employees off the UI rolls if they become unemployed. Paying workers "under the table" is another method cited by state officials that employers use to circumvent the UI system. Such actions essentially keep workers ineligible for UI benefits.

In contrast, Florida officials reported that circumvention of UI laws is not a major problem because the state charges UI benefit costs to an employer on a pro rata basis related to duration of employment. So, it is not expedient for employers to purposely lay off or fire employees to avoid UI charges. For example, if a UI beneficiary had worked for one company for 18 weeks and later gained employment with another company for 3 weeks before being laid off, the first company is charged with the majority of UI costs for that claimant.

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### Misclassification of Independent Contractors and Consultants Is a Growing Concern

Officials in five states reported that employer misclassification of workers as independent contractors who are not eligible for UI benefits is a growing problem that has caused a decrease in workers covered by UI. Reasons given for this classification include (1) an increasing financial burden placed on employers due to increasing UI costs; (2) a preference of many workers to work on an hourly basis, rather than on salary; and (3) a reduction in costs because employers normally do not pay benefits, such as retirement and health care, to independent contractors and consultants.

Two states were proposing legislation to curb the misclassification of workers as independent contractors or consultants.<sup>11</sup> In California, the legislature was considering a bill targeting single-purpose service firms that would require classification of workers as employees, rather than consultants or independent contractors, unless evidence showed that a worker was truly independent of the employer. Colorado has drawn up its own legislation defining independent contractors. Before 1989, Colorado had followed Internal Revenue Service guidelines defining an independent

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<sup>11</sup>As of May 1993, no state had approved such legislation.

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contractor, but numerous problems in categorizing workers prompted the state to implement its own guidelines.

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## Employee Leasing Affects UI Reciprocity

Another factor that some state officials cited as contributing to declining numbers of UI recipients is the practice of employee leasing. Leasing companies provide workers to employers, relieving employers from dealing with (1) many state and federal regulations, (2) the hiring and firing of employees, (3) payroll systems, (4) employee health plans, and (5) employee-related paperwork. Leasing companies sell their service by stressing the increase in efficiency that this affords employers.

State officials reported, however, that although it provides some benefits, employee leasing presents some important and problematic drawbacks. Among these, Florida officials cited (1) confusion over who is actually the corporate entity, (2) confusion over whose experience rating (the employer's or the leasing company's) is applicable, (3) employees rarely knowing who actually is their employer, and (4) accountability when employees face problems such as equal employment opportunity and sexual harassment complaints.

Kentucky officials cited additional concerns about employee-leasing companies—primarily, determining whether the employee-leasing entity or the actual employer is responsible for the benefit charges for employees who lose their jobs and the effect of such companies on UI taxes collected. To address these problems, two states are considering or have passed legislation to make the employee-leasing entity and the actual employer coemployers so the state could recoup benefit charges from the actual employer if the leasing company fails. The National Association of Leasing Companies supports similar legislation aimed at eliminating illegitimate employee-leasing companies.

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## Structural Changes Also Affect Reciprocity

State officials also cited significant structural changes in the work force, such as service and retail jobs replacing manufacturing jobs, as contributing to the decline in UI reciprocity. Traditionally, a greater proportion of unemployed from manufacturing jobs received UI benefits than did those from service and retail jobs. This is in part because service and retail jobs typically are low-wage and part-time positions that often do not allow workers to qualify for UI benefits. In addition, these workers may be less knowledgeable of their entitlement to UI benefits than other workers and, therefore, not as likely to apply for UI.

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Notable changes in the number of workers employed in manufacturing and service occupations have occurred in some states. For example, the number of manufacturing employees in Michigan declined from 1.2 million in 1978 to 944,000 by 1990. This represents a decrease in manufacturing jobs from 33 percent of the total work force in 1978 to 24 percent in 1990. Michigan officials stated that more workers are now employed in service and retail jobs, positions most adversely affected by state UI legislative changes that increased qualifying wage and weeks worked requirements.

# Decline in UI Reciprocity Rates Affects Program's Ability to Meet Objectives

The UI system's ability to meet its goals of helping to stabilize the economy during times of high unemployment and providing temporary and partial wage replacement to the unemployed is impaired. The funding provided during recessions to help stabilize the economy is now substantially lower in relative terms than during recessions of the 1960s and 1970s and a lower share of the unemployed now receive UI benefits. However, those who receive benefits still get about the same proportion of their former wages replaced by UI benefits. In addition, as the poverty rate for unemployed workers increased between 1980 and 1990, receiving UI benefits became more important in keeping an unemployed worker's family above the poverty line.

## Ability of UI Program to Stabilize the Economy Has Diminished

If the UI reciprocity rate and benefit payments were at the same level during the 1990-91 recessionary period as during the 1974-75 period, we estimate that about \$20 billion more in UI benefits would have been available to help stabilize the economy and maintain a portion of the incomes of the unemployed. The UI system paid about \$50 billion in benefits in 1990-91. Had the system paid benefits at the same rate and to the same proportion of the unemployed as it did in 1974-75, after correcting for inflation and unemployment levels, an estimated \$70 billion of benefits would have been paid in 1990 and 1991.<sup>12</sup> Half the difference was due to a decline in the payment of regular benefits, and half was due to a decrease in extended benefit payments.

Another way to view the impact of the declining UI reciprocity rate is to examine the extent to which UI benefits replaced the lost wages of not only those receiving UI benefits but all unemployed workers.<sup>13</sup> The percentage of the total wages lost through unemployment that were replaced by UI benefits declined by one-third between 1980 and 1984, from about 16 percent to 10 percent (see table 3.1). This meant that in 1984, UI benefits replaced about 10 percent of the total wages lost by all unemployed workers. Using comparable points in the business cycle showed similar results. For example, between 1978 and 1988 (each of which preceded a recession by 2 years), the total wages lost through unemployment that

<sup>12</sup>We calculated the amount that would have been paid in UI benefits in 1990-91 using the UI regulations and procedures in existence during other recessions. We did this by calculating UI benefits per unemployed person in various years, adjusting for inflation. Multiplying these figures by the number of unemployed in 1990-91 yielded the total dollar amount of benefits that would have been paid in 1990-91 had the system paid benefits at the previous rate.

<sup>13</sup>For each year, we multiplied the average wage replacement rate by the proportion of unemployed who received benefits (UI reciprocity rate). The results provided the percentage of total wages that UI benefits would have replaced had all unemployed workers been employed.

were replaced by UI decreased by more than 20 percent, from 14 percent to 11 percent. Similarly, between 1980 and 1990 (recessionary years) the portion of total lost wages replaced by UI benefits decreased by about 18 percent. The total wages replaced by UI benefits in individual states for selected years appears in appendix I.

Table 3.1: UI Benefits as a Proportion of Lost Wages Fell During 1980s

Year	Percent of lost wages that UI benefits replaced
1978	14
1980	16
1984	10
1988	11
1990	13

Individually, most states showed a decline in the percentage of total lost wages that were replaced by UI benefits. In 47 states, this percentage decreased between 1980 and 1984, the years when UI reciprocity declined the most. Overall, between 1978 and 1988, comparable years in the economic cycle, the percentage decreased in 40 states.

### A Stable Wage Replacement Rate Provided to a Smaller Percentage of the Unemployed

Although the percentage of unemployed individuals receiving UI benefits has declined, the portion of a UI recipient's wages lost through unemployment that is replaced by UI benefits has remained fairly constant. Between 1978 and 1990, the UI program replaced an average of about 36 percent of the wages lost by those who received benefits. While the wage replacement rate may have varied by state and fluctuated within a state from year to year, it remained relatively constant nationwide. As shown in table 3.2, the nationwide wage replacement rate averaged 36 percent in 4 of the 5 years included and 35 percent in the remaining year. The most notable change occurred in the number of states providing the lowest wage replacement rates. Between 1978 and 1990, the number providing a wage replacement rate of less than 30 percent increased from 1 to 6 and the number providing a wage replacement of 30 to 34.9 percent decreased from 16 to 10. The number of states within each of the remaining numerical groupings remained relatively constant during these 5 years. The wage replacement rates for individual states, in selected years, are shown in appendix I.

**Table 3.2: Changes in Wage Replacement Rates**

Year	National average (percent)	Number of states with wage replacement rate of:				
		<30%	30-34.9%	35-39.9%	40-44.9%	>45%
1978	36	1	16	17	16	1
1980	36	2	13	20	13	3
1984	36	5	12	20	11	3
1988	35	7	10	19	15	0
1990	36	6	10	19	15	1

## Characteristics of UI Recipients Have Changed as Reciprocity Has Declined

Today's UI recipients are somewhat different from past recipients: minorities and college graduates are slightly more likely to receive UI benefits now, and nonminorities and those with less education are less likely to receive benefits. These differences reflect changes in the labor force as well as changes to UI laws and regulations. In conducting this analysis, we used Current Population Survey data to compare UI recipients with unemployed nonrecipients in 1980 and 1990. We chose these years because they represent similar points in the business cycle and provide the fairest comparison; different economic conditions would affect the composition of the unemployed population. Both 1980 and 1990 were the first years of a recession.

The percentage of unemployed women receiving UI benefits in 1990 was somewhat closer to that of men than it was in 1980, and reciprocity among blacks and other minorities drew closer to that of whites. Traditionally, unemployed men are more likely to receive UI benefits than are women. Similarly, whites and middle-aged or older workers are more likely to receive benefits than blacks or younger workers. Overall, between 1980 and 1990, UI reciprocity fell for all groups except for minority and college-educated unemployed workers and remained constant for women (see table 3.3).

**Table 3.3: UI Reciprocity Rates for  
Different Demographic Groups, 1980  
and 1990**

Demographic Group	Percent of unemployed group receiving UI benefits	
	1980	1990
Men	42	38
Women	31	31
White	40	37
Black/other	27	28
Less than high school education	35	29
High school education, no college	43	40
College	31	33
Age 16-24	22	14
Age 25-54	46	42
Age 55 +	53	50

## UI Benefits Reduce Likelihood of Poverty

Although the poverty rate for all unemployed workers increased between 1980 and 1990, it did so to a lesser extent among those who received UI benefits. This indicates the increased importance of UI benefits in reducing the likelihood that an unemployed worker's family would be in poverty.

Our analyses showed that, over time, receiving UI benefits was an important factor in keeping male heads of household above the poverty level. For example, the poverty rate for all unemployed male heads of household, when counting only their own income, increased from 27 percent to 32 percent between 1980 and 1990. However, a substantial difference existed between those who did not receive UI benefits and those who did. Among the unemployed male heads who did not receive UI benefits, the poverty rate increased from 39 to 45 percent. On the other hand, the poverty rate of UI recipients was much lower than nonrecipients, and that remained about the same between 1980 and 1990, increasing from 17 to 18 percent (see table 3.4).<sup>14</sup>

<sup>14</sup>UI recipients are less likely to be in poverty than nonrecipients because (1) UI benefits contribute to total income, helping to keep recipients above the poverty threshold, and (2) UI eligibility depends on work experience and wages earned, so recipients are more likely to have greater incomes than nonrecipients. We determined that, in 1990, less than 30 percent of the difference in recipient and nonrecipient poverty rates was due to UI benefits, and more than 70 percent to other factors, such as the hours worked and wages earned (see app. III).

**Chapter 3**  
**Decline in UI Reciprocity Rates Affects**  
**Program's Ability to Meet Objectives**

**Table 3.4: Poverty Rates, Unemployed Male Head of Household and UI Reciprocity**

Male head of household	Poverty rate (percent) in	
	1980	1990
Including only worker's own income		
Received UI	17	18
Did not receive UI	39	45
Including all family income		
Received UI	9	7
Did not receive UI	24	26

We obtained similar results when including all family members' incomes. The poverty rates were lower for male UI recipients than nonrecipients and fell slightly between 1980 and 1990. Poverty rates increased for nonrecipients but not to the extent that they did when including only the worker's income.<sup>15</sup>

The reduction in the proportion of unemployed workers receiving UI benefits appears to have contributed to an increase in the poverty population. We estimated that, if the UI reciprocity rate in 1990 had been the same as it was in 1980, as many as 260,000 additional people would have been above the poverty line because of receiving UI benefits. Using the 1980 UI reciprocity rate, more than 500,000 additional unemployed workers would have received UI benefits in 1990. Of these, we estimate that approximately 130,000 unemployed workers would have been in poverty, of whom about 87,000 would have received UI benefits sufficient to raise family income above the poverty level.<sup>16</sup> Furthermore, assuming that the 87,000 people came from average-sized families, the family income of about 260,000 individuals overall would have been above the poverty level.<sup>17</sup>

<sup>15</sup>Households headed by women were more likely than those headed by men to be in poverty in both 1980 and 1990. The reason was that women who headed households were less likely to have other sources of income than were men because most did not have a spouse present.

<sup>16</sup>To estimate the number of additional beneficiaries under the UI system of 1980, we multiplied the difference in the 1980 and 1990 UI reciprocity rates, or 2.4 percent, by the number of unemployed workers. We then multiplied this number by the difference in poverty rates for recipients and nonrecipients for all family income, or 16.4 percentage points, to estimate those who might have moved from poverty to nonpoverty status.

<sup>17</sup>For other analyses of poverty and unemployment insurance using monthly rather than annual data, see Congressional Budget Office, *Family Incomes of Unemployment Insurance Recipients and the Implications for Extending Benefits*, Feb. 1990, and Congressional Research Service, *Unemployed Workers Who Do Not Receive Unemployment Compensation: Impact and Incidence*, 90-566 EPW, Nov. 15, 1990. Both studies show that UI helps raise families with unemployed workers out of poverty.



# Conclusions and Agency Comments

During the first several decades of the program, the UI system operated on a forward-funded basis, that is, states used funds accumulated during periods of economic growth to pay benefits during economic downturns. Three major recessions in the 1970s and early 1980s depleted many state trust fund reserves. Since then, many states have relied on federal loans to continue paying benefits, thus eroding the forward-funded principle.

The Congress enacted legislation in the early 1980s to improve the financial condition of the UI system. This followed a period when nearly half of the states had exhausted their trust fund balances and had to borrow from the federal government to continue paying benefits to the unemployed. These changes made it more expensive for the states to borrow federal funds and encouraged them to act to maintain or restore trust fund solvency by reducing expenditures and increasing UI tax revenue. State actions included making it more difficult for individuals to qualify for UI assistance, reducing the length of time claimants could receive benefits, and limiting the amount of benefits paid. These efforts to maintain solvency were relatively successful, with few states having to borrow funds in the last 5 years to continue paying UI benefits. However, following these changes, a smaller portion of unemployed workers were eligible or applied for UI benefits.

Our analysis demonstrated that declining state UI trust fund solvency status was associated with state program changes that led, in turn, to a decline in the proportion of the unemployed population receiving UI benefits. Consequently, the UI program's ability to achieve its objectives was jeopardized; that is, a lower proportion of unemployed individuals now receive benefits, and less money is available to stabilize the economy during recessions.

Because of the changing workplace, today's UI system operates in a different environment than in the past. The system was established to provide temporary wage replacement to workers with substantial work histories who were laid off. The expectation was that many of these workers would eventually return to their former jobs. Increasingly today, unemployment leads to worker dislocation and many jobs are lost forever. Given this environment, the UI system does not meet its primary objectives to the extent that it once did.

The Congress has established the Advisory Council on Unemployment Compensation under the Emergency Unemployment Compensation Act of 1991 (P.L. 102-164) to evaluate the UI program, including the purpose,

goals, countercyclical effectiveness, coverage, benefit adequacy, and trust fund solvency; and to report its findings and recommendations to the President and the Congress. The Advisory Council, therefore, has the opportunity to address the long-run changes that have occurred in the economy and their impact on the UI system.

## Agency Comments and Our Evaluation

In comments on a draft of this report, dated July 13, 1993 (see app. IV), Labor expressed some reservations with GAO's report. The Department was concerned with the approach followed on this assignment, with what it perceived as report inaccuracies, and with the overall focus of the report. The following provides additional details on their comments and our response.

Labor believed that GAO failed to make full use of existing research results "as noted in the bibliography" and instead relied to a great extent on anecdotal information. Contrary to Labor's view, we based our conclusions primarily on the results of our analytical model, supplemented by anecdotal information used to illustrate the impact of the financial condition of state UI trust funds on their program operations. We obtained this anecdotal information from state officials responsible for administering state UI programs and with first-hand information on the history and operation of their programs. We also reviewed, extensively, the previous research studies that focused on declining UI reciprocity rates and used the results in developing our study approach, in doing our work, and in formulating our conclusions. For example, two of the three economic factors that Labor cites as not being addressed in our work were included in our analytical model. We also controlled for the third factor—geographic shifts in unemployment by state and region—by using a statistical methodology that took into account program differences between states. As Labor indicates, the author of one of these studies participated in our work; however, he did so only in an advisory capacity—commenting on our planned analytical approach, assisting us in choosing states to visit, and reviewing and commenting on our draft report.

Labor also stated that the report ignored changes to the UI extended benefits program and the impact of such changes on the proportion of the unemployed who received UI benefits. Consistent with previous research, our analysis focused on the decline in receipt of regular UI benefits, excluding extended benefits. Those who receive extended benefits are not customarily included when computing the UI reciprocity rate—the ratio of

those receiving regular UI benefits to the total number of unemployed individuals. Therefore, the decrease in the number of extended benefit recipients did not affect the calculation of reciprocity rates in our analysis.

Labor also referred to a few statements in the report as inaccurate. However, it appears that this interpretation may be due more to semantics than factual errors. An error in a third statement cited by Labor was due to an editorial oversight. We have modified the report to more clearly convey our intended meaning and to correct the editorial oversight.

Labor also raised concerns about our discussion of the relevancy of current UI objectives and our conclusion that the objectives may be jeopardized. Labor stated that “. . . in fact, the objectives are not jeopardized. What may be jeopardized is the effectiveness [of] UI as the sole means of achieving the objectives.” Our intended meaning is that, if the UI program fails to meet, or only partially meets, its stated objectives, then perhaps the program needs to be changed to better achieve those objectives. We have made changes to more clearly convey this point.

# Selected UI-Related Data by State, for Selected Years

State	Reiplency Rate (IU/TU ratio)				Wage Replacement Rate (percent)				Total Wages Replaced (percent)			
	1978	1980	1984	1990	1978	1980	1984	1990	1978	1980	1984	1990
Alabama	34.5	38.6	21.3	27.9	34.6	31.9	31.5	30.0	11.9	12.3	6.7	8.4
Alaska	65.7	62.6	47.9	62.1	21.6	18.8	25.1	28.5	14.2	11.8	12.0	17.7
Arizona	21.4	28.4	27.2	29.0	34.3	31.8	31.0	33.1	7.3	9.0	8.4	9.6
Arkansas	37.0	45.7	26.8	33.9	39.0	40.1	34.5	38.6	14.4	18.3	9.2	13.1
California	40.1	47.2	35.5	45.8	31.0	29.5	29.5	26.2	12.4	13.9	10.5	12.0
Colorado	22.8	25.7	29.4	25.0	41.4	40.3	40.5	38.6	9.4	10.4	11.9	9.7
Connecticut	47.1	39.4	33.5	49.5	37.4	36.4	35.1	36.0	17.6	14.3	11.8	17.8
Delaware	32.3	38.1	27.2	25.5	37.8	37.1	32.1	37.6	12.2	14.1	8.7	9.6
District of Columbia	35.9	43.5	31.6	42.2	40.7	38.9	33.6	35.0	14.6	16.9	10.6	14.8
Florida	22.4	25.7	16.8	20.3	31.9	31.1	34.1	36.6	7.1	8.0	5.7	7.4
Georgia	27.3	31.6	22.8	26.7	35.7	32.2	31.8	34.0	9.7	10.2	7.2	9.1
Hawaii	32.3	48.6	41.0	37.0	43.8	42.6	46.2	44.8	14.2	20.7	18.9	16.6
Idaho	40.1	46.5	37.6	38.8	41.8	40.3	40.4	40.3	16.8	18.7	15.2	15.6
Illinois	45.2	46.3	26.5	32.4	38.0	38.0	35.6	35.1	17.2	17.6	9.4	11.4
Indiana	22.1	35.5	21.9	22.9	32.1	30.8	27.0	25.8	7.1	10.9	5.9	5.9
Iowa	40.2	42.7	27.5	31.5	49.3	46.7	43.3	43.9	19.8	20.0	11.9	13.8
Kansas	38.3	44.5	30.2	33.3	41.1	42.5	41.0	44.4	15.7	18.9	12.4	14.8
Kentucky	38.4	45.7	21.9	29.7	36.5	39.8	31.5	35.9	14.0	18.2	6.9	10.7
Louisiana	28.0	34.6	30.0	25.6	41.3	39.6	44.9	26.0	11.6	13.7	13.5	6.7
Maine	48.5	44.9	43.4	52.5	39.8	38.9	39.8	41.7	19.3	17.5	17.3	21.9
Maryland	28.5	34.5	30.6	31.9	34.7	35.6	36.9	36.6	9.9	12.3	11.3	11.7
Massachusetts	45.7	50.7	41.9	59.7	37.6	37.0	36.8	42.5	17.2	18.8	15.4	25.4
Michigan	44.1	53.4	21.0	35.3	33.1	31.6	35.8	41.9	14.6	16.9	7.5	14.8
Minnesota	41.0	40.5	27.3	35.3	43.0	44.4	42.4	42.9	17.6	18.0	11.6	15.2
Mississippi	24.6	40.0	23.7	26.6	33.7	32.4	32.5	33.2	8.3	12.9	7.7	8.8
Missouri	44.5	48.1	26.3	34.5	34.3	33.9	27.7	32.6	15.3	16.3	7.3	11.2
Montana	40.3	49.2	34.2	32.8	42.0	40.8	45.2	40.8	16.9	20.1	15.5	13.4
Nebraska	35.8	36.2	33.2	40.6	40.6	40.5	35.7	34.1	14.5	14.7	11.8	13.8
Nevada	49.5	43.0	29.2	38.7	36.4	37.0	37.6	38.1	18.0	15.9	11.0	14.8
New Hampshire	25.2	35.3	25.9	30.7	38.0	36.5	36.6	29.7	9.6	12.9	9.5	9.1
New Jersey	47.6	52.6	39.9	51.8	35.7	34.8	35.3	37.9	17.0	18.3	14.1	19.6
New Mexico	28.5	26.9	27.1	23.7	34.2	33.6	36.1	34.9	9.7	9.0	9.8	8.3
New York	43.3	45.0	36.0	48.6	32.7	31.4	30.9	32.6	14.2	14.1	11.1	15.8
North Carolina	31.2	35.7	24.4	40.3	37.0	38.2	35.3	39.3	11.5	13.7	8.6	15.9
North Dakota	41.3	47.7	39.9	30.7	44.9	45.6	47.9	40.8	18.6	21.7	19.1	12.5
Ohio	32.8	49.0	24.8	32.2	40.6	43.6	39.3	35.5	13.3	21.3	9.7	11.4

(continued)

**Appendix I  
Selected UI-Related Data by State, for  
Selected Years**

State	Reiplency Rate (IU/TU ratio)				Wage Replacement Rate (percent)				Total Wages Replaced (percent)			
	1978	1980	1984	1990	1978	1980	1984	1990	1978	1980	1984	1990
Oklahoma	25.3	26.8	20.2	20.1	35.9	37.8	40.5	39.2	9.1	10.1	8.2	7.9
Oregon	43.1	50.1	31.7	45.4	35.1	36.3	38.5	40.0	15.1	18.2	12.2	18.1
Pennsylvania	50.2	55.9	36.4	47.2	42.1	42.2	41.8	42.1	21.1	23.6	15.2	19.9
Rhode Island	73.5	60.3	48.2	57.1	38.7	37.5	37.8	45.4	28.4	22.6	18.2	25.9
South Carolina	26.9	39.9	27.0	33.2	38.8	36.4	32.5	34.9	10.4	14.5	8.8	11.6
South Dakota	39.0	27.5	16.5	16.0	44.8	46.6	41.5	38.9	17.5	12.8	6.8	6.2
Tennessee	37.8	46.4	21.4	41.1	33.2	32.8	28.3	29.0	12.5	15.2	6.1	11.9
Texas	19.4	22.2	19.7	21.4	30.2	31.1	38.7	37.4	5.8	6.9	7.6	8.0
Utah	43.2	36.7	28.9	24.1	42.2	41.4	42.1	43.2	18.2	15.2	12.1	10.4
Vermont	42.8	50.9	44.9	53.2	39.8	40.1	39.2	38.0	17.0	20.4	17.6	20.2
Virginia	19.9	29.1	16.7	20.4	40.8	39.4	34.6	34.3	8.1	11.4	5.8	7.0
Washington	38.8	44.8	34.0	50.1	34.9	37.1	39.5	39.2	13.6	16.6	13.4	19.6
West Virginia	48.8	46.8	23.2	25.5	31.9	38.3	38.5	37.1	15.6	17.9	8.9	9.5
Wisconsin	39.9	58.6	34.4	43.7	42.1	44.8	41.8	42.3	16.8	26.2	14.4	18.5
Wyoming	33.2	30.5	28.2	23.5	33.4	35.9	35.2	41.8	11.1	10.9	9.9	9.8

# GAO's Analysis of the Effects of State Trust Fund Solvency on UI Reciprocity

Low balances in state UI trust funds played a role in state legislative changes that, in turn, affected UI reciprocity during the 1980s. We used regression analysis to examine the relationships among the insured-to-total unemployed ratio, state UI laws, and state trust fund solvency from 1978 to 1990. We found that states with low trust fund balances for several consecutive years tended to have lower wage replacement rates, higher payroll tax rates, and, to some extent, higher minimum earnings requirements. The low wage replacement rates and high minimum earnings requirements, in turn, led to lower reciprocity rates.

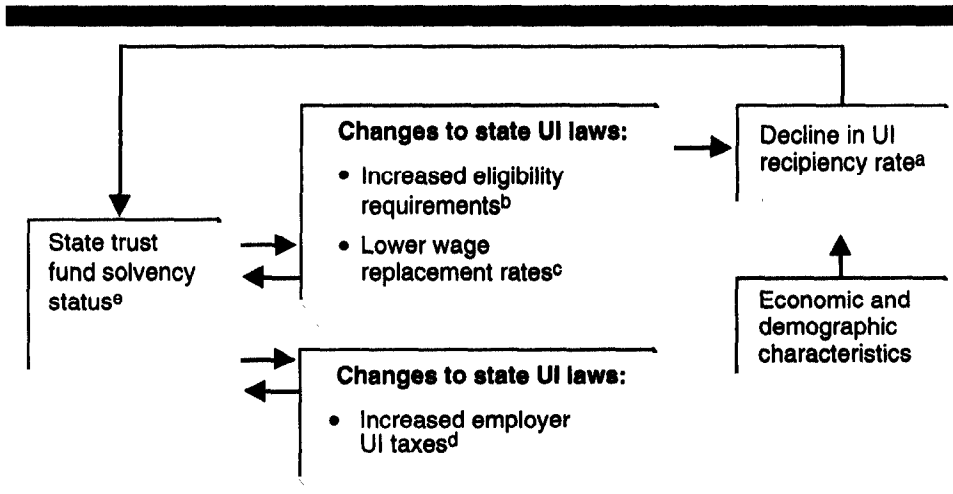
## Objectives and Scope

We analyzed the causes of the decline in UI reciprocity between the late 1970s and 1990. A review of the literature, conversations with a consultant, and our interviews with state UI officials in seven states indicated that the causes were multiple and linked. Changing demographics played a role as more women and minority group members and fewer manufacturing-sector and blue collar workers became unemployed. In addition, many states changed their UI laws during the early 1980s, a time when federal UI laws also changed. Some of the law changes appeared to be related to states' concerns for the solvency of their trust funds.

Our model, depicted in figure II.1, was based on the premise that past solvency status, as measured by the high cost multiple, would influence current laws, which in turn would affect UI reciprocity. Specifically, we believed that the following relationships should be observed:

- states with generous UI benefit laws would have high UI reciprocity, holding constant the demographic and economic characteristics of the unemployed;
- state UI laws would be determined in part by the solvency status of the state's UI trust fund, with a lagged effect, so that states near insolvency would impose low benefits or high taxes; and
- high UI reciprocity would reduce solvency and thus have a lagged effect on laws.

Figure II.1: GAO's Model of UI  
 Reciprocity and Trust Fund Solvency



<sup>a</sup>See table II.2  
<sup>b</sup>See table II.3  
<sup>c</sup>See table II.4  
<sup>d</sup>See table II.5  
<sup>e</sup>See table II.6

We analyzed 1978 to 1990 state data, and our data set included 663 observations.<sup>1</sup> Table II.1 shows the variables we included.

<sup>1</sup>We included the 50 states and the District of Columbia. Current Population Survey data on the characteristics of the unemployed were not always available by state prior to 1978. In addition, they were unavailable after 1990 when we conducted our analysis, and were not available for Puerto Rico or the Virgin Islands. To obtain lagged values for one of our variables, we gathered data beginning in 1973.

**Appendix II  
GAO's Analysis of the Effects of State Trust  
Fund Solvency on UI Reciprocity**

**Table II.1: Variables Used in Estimation**

		Mean of variable	Standard deviation of variable
<b>Endogenous variables</b>			
IU/TU ratio	Insured unemployed to total unemployed ratio	0.346	0.102
Minimum earnings requirement	Minimum earnings in base period required to qualify for UI benefits, standardized to annual earnings and measured in thousands of 1990 dollars	1.395	0.660
Replacement rate	UI wage replacement rate, measured as average UI benefit as percentage of average wage	0.372	0.0512
Tax rate	Average employer UI tax rate, measured as tax revenues as percentage of total wages	1.166	0.511
High cost multiple	High cost multiple, a measure of solvency of the state's UI trust fund	0.506	0.616
<b>Exogenous variables</b>			
Demographics	Six variables describing demographics and previous job experience of the state's unemployed population:		
	Percentage that are men	0.544	0.0532
	Percentage that are white	0.769	0.183
	Percentage from blue collar jobs	0.393	0.0757
	Percentage from manufacturing jobs	0.189	0.0817
	Percentage who are long-term unemployed	0.123	0.0586
	Percentage who are job losers	0.478	0.0789
Union	Percentage of employees in the state who are union members	0.177	0.0715
Year	Dummy variable equal to one for the years from 1982 onwards and zero otherwise	0.692	0.462
Unemployment rate	Total unemployment rate	0.0674	0.0229
High cost multiple lags	High cost multiple values from the previous year and from 2, 3, 4, and 5 years ago	0.375 to 0.472	0.617 to 0.723

## Methodology

We estimated a simultaneous equations system that linked UI reciprocity, state trust fund solvency, and state UI laws. Two-stage least squares estimation allowed us to obtain consistent parameter estimates given the simultaneous nature of the process. In addition, we used panel data methods with a correction for autoregressive error terms to account for the repeated observations of each state in our data set.

We applied two-stage least squares analysis to the data, which allows estimation when the dependent variable of one equation within a system



of equations serves as an independent variable in another equation.<sup>2</sup> We generated predicted values for each independent variable that was a dependent variable in another equation by regressing it on a set of fully independent variables. We then used these predicted values in place of the actual values of the variables in the final regression.

Furthermore, to exploit the nature of the data, we also used panel estimation methods with an autocorrelation correction. Because the data were arranged in a panel format, each observation was not an independent draw. Each group of 13 observations was linked, because they were from the same state. Moreover, within each group of 13, the data are time-series in nature. Our methodology allowed us to account for error terms that might have been correlated across time within a state.<sup>3</sup>

The first equation estimated the effect of UI laws and state demographics on UI reciprocity (see table II.2). A high wage replacement rate would make it worthwhile for people to apply for benefits, while a high minimum earnings requirement would make fewer people eligible. Prior studies indicated that certain demographic characteristics of a state's unemployed population, as well as such factors as the proportion of unemployed who are long-term unemployed or who have lost their jobs, also help determine reciprocity rates. The long-term unemployed may exhaust their UI benefits, and a state with a high proportion of long-term unemployed may have a low reciprocity rate. On the other hand, because those who lost their jobs are the category of unemployed most likely to apply for and receive benefits, states with a high proportion of job losers among their unemployed are likely to have high reciprocity rates. We also included a variable to distinguish between observations from before and after 1982 to determine whether federal law changes made in 1982 had a direct effect on state UI reciprocity levels.

The next three equations estimated the values of three state UI laws—the benefit replacement rate (table II.3), the minimum earnings requirement (table II.4), and the tax rate on all wages (table II.5). If the high cost multiple in a state has been low, a state may raise taxes, raise its minimum earnings requirement, or reduce benefits by reducing the replacement rate.

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<sup>2</sup>In an ordinary least squares regression, if an independent variable in an equation is affected by the dependent variable, the resulting estimates are biased. For example, in our system of equations, state UI laws in part determine UI reciprocity, but the reciprocity level, by affecting trust fund solvency, itself influences the UI laws.

<sup>3</sup>The Durbin-Watson statistic and the autocorrelation from a preliminary two-stage least squares regression indicated that there were time-series problems—that error terms were correlated across observations. Standard error estimates are not correct in the presence of these problems.

These effects were thought to occur if the values of the other laws not being estimated by each equation were held constant. We expected that a state with a high replacement rate, for example, would need to have a high tax rate to raise the revenues to support that replacement rate, all else equal.

Finally, we expected a state's solvency status, as measured by the high cost multiple, to be affected by the three laws as well as the UI reciprocity rate and the unemployment rate (table II.6). If either UI reciprocity or unemployment went up, the trust fund would be drawn down and solvency would decrease.

In developing our model, we made certain choices and simplifying assumptions regarding the factors we wanted to include. No econometric model can completely capture all facets of an economic process, but we believe our model represents, as best a relatively straightforward model can, the effects that trust fund solvency played in UI reciprocity. The equation we used for the determinants of the reciprocity rate includes variables other researchers have used and found to be significant. We extended prior research by including a simultaneous approach to the determination of reciprocity, state UI laws, and solvency.

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## Results

The replacement rate and the minimum earnings requirement had the effects we had expected—a high replacement rate led to increased UI reciprocity, while a high minimum earnings requirement tended to reduce reciprocity (see table II.2). Coefficients for both variables were significant and in the expected direction, as were coefficients for the percents of manufacturing, union, long-term unemployed, and job losers.

Tables II.2, II.3, II.4, II.5, and II.6 contain the regression results.

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**Table II.2: Regression Results for Ratio of Insured to Total Unemployed**

<b>Variable</b>	<b>Coefficient</b>	<b>Standard error</b>	<b>T-ratio</b>
Replacement rate <sup>b</sup>	0.413	0.217	1.90
Minimum earnings requirement (thousands of dollars) <sup>a</sup>	-0.0494	0.0201	-2.46
Percent of unemployed who were men	0.0832	0.0571	1.46
Percent of unemployed who were white <sup>a</sup>	0.154	0.0525	2.94
Percent of unemployed who were blue collar <sup>a</sup>	0.242	0.0453	5.34
Percent of unemployed from manufacturing	-0.0665	0.0822	-0.81
Percent of unemployed who were long term <sup>a</sup>	-0.489	0.0505	-9.67
Percent of unemployed who were job losers <sup>a</sup>	0.157	0.0544	2.88
Union <sup>a</sup>	0.192	0.0845	2.28
Year (equals 1 for 1982-1990)	-0.00708	0.00809	-0.88

<sup>a</sup>Significant at the 5-percent level.

<sup>b</sup>Significant at the 10-percent level.

**Table II.3: Regression Results for Minimum Earnings Requirement**

<b>Variable</b>	<b>Coefficient</b>	<b>Standard error</b>	<b>T-ratio</b>
Tax rate <sup>a</sup>	0.599	0.187	3.20
Replacement rate	0.699	0.806	0.87
Union <sup>b</sup>	-1.13	0.629	-1.80
HCMLag <sup>a</sup>	0.154	0.0722	2.14
HCMLag2	0.117	0.118	1.00
HCMLag3	-0.0141	0.0875	-0.16
HCMLag4	-0.0751	0.0712	-1.05
HCMLag5	-0.0883	0.0566	-1.56
Year (equals 1 for 1982-1990) <sup>a</sup>	0.199	0.0519	3.83

Note: Minimum earnings requirement measured in thousands of dollars.

<sup>a</sup>Significant at the 5-percent level.

<sup>b</sup>Significant at the 10-percent level.

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**Table II.4: Regression Results for  
Replacement Rate**

<b>Variable</b>	<b>Coefficient</b>	<b>Standard error</b>	<b>T-ratio</b>
Tax rate <sup>a</sup>	0.162	0.0224	7.22
Minimum earnings requirement (thousands of dollars)	-0.00929	0.0169	-0.55
Union	0.0708	0.0775	0.91
HCMLag <sup>a</sup>	0.0293	0.00907	3.23
HCMLag2 <sup>a</sup>	0.0612	0.0133	4.61
HCMLag3	0.00880	0.0109	0.81
HCMLag4 <sup>a</sup>	0.0200	0.00874	2.29
HCMLag5	-0.00969	0.00710	-1.37
Year (equals 1 for 1982-1990) <sup>a</sup>	0.0205	0.00713	2.88

<sup>a</sup>Significant at the 5-percent level.

**Table II.5: Regression Results for Tax  
Rate**

<b>Variable</b>	<b>Coefficient</b>	<b>Standard error</b>	<b>T-ratio</b>
Replacement rate <sup>a</sup>	2.669	0.511	5.22
Minimum earnings requirement (thousands of dollars) <sup>a</sup>	0.292	0.0850	3.44
Union <sup>a</sup>	0.912	0.424	2.15
HCMLag <sup>a</sup>	-0.332	0.0471	-7.05
HCMLag2 <sup>a</sup>	-0.209	0.0625	-3.35
HCMLag3	-0.0220	0.0613	-0.36
HCMLag4	-0.0221	0.0490	-0.45
HCMLag5	-0.0166	0.0388	-0.43
Year (equals 1 for 1982-1990)	-0.0380	0.0403	-0.94

<sup>a</sup>Significant at the 5-percent level.

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**Table II.6: Regression Results for High Cost Multiple**

<b>Variable</b>	<b>Coefficient</b>	<b>Standard error</b>	<b>T-ratio</b>
Tax rate <sup>a</sup>	0.350	.164	2.13
Replacement rate	-0.480	1.26	-0.38
Minimum earnings requirement (thousands of dollars) <sup>a</sup>	0.245	0.0994	2.46
IU/TU ratio <sup>a</sup>	-1.29	0.346	-3.72
Unemployment rate <sup>a</sup>	-8.00	0.921	-8.69
HCMLag <sup>a</sup>	0.871	0.0425	20.48
HCMLag2	0.0266	0.0745	0.36
HCMLag3	0.0559	0.0520	1.08
HCMLag4 <sup>a</sup>	-0.0911	0.0465	-1.96
HCMLag5	0.0141	0.0246	0.57
Year (equals 1 for 1982-1990)	-0.0375	0.0357	-1.05

<sup>a</sup>Significant at the 5-percent level.

We determined the magnitude of the effects of our variables on the insured-to-total unemployed ratio. A \$1,000 increase in the minimum earnings requirement would, with everything else constant, result in a 4.9-percentage point decrease in the reciprocity rate. At the mean, the rate would decrease from 36.8 percent to 31.9 percent. A 10-percentage point increase in the replacement rate would, all else equal, increase reciprocity by 4.1 percentage points.<sup>4</sup>

Results of the regressions for the determinants of state laws showed that lagged values of the high cost multiple indeed affected the laws. Tax laws were especially sensitive, with low values of the high cost multiple strongly indicative of a high current tax rate—that is, states with solvency problems for the previous several years tended to have high tax rates in the current year. The replacement rates and minimum earnings requirements were also influenced by past solvency status, although the results were less clear. Low values of the high cost multiple led to somewhat lower replacement rates, as we expected, but they led to higher minimum earnings requirements only after a lag of several years. In other words, if a state had a low trust fund balance, it tended to have a lower earnings requirement for 2 years before it raised the requirement.

<sup>4</sup>These estimates are based on the individual state observations and are not weighted by the states' populations.

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Overall, the model performed well. Most of the key variables were statistically significant and of the expected sign.<sup>6</sup> With the autoregression correction, none of the five equations had an estimated autocorrelation above 0.13.

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<sup>6</sup>Computed R-squared figures for two-stage least squares do not convey the standard measure of goodness-of-fit and thus are not reported here.

# Extent to Which UI Benefits Reduce Poverty Levels

We performed an analysis to determine the extent to which UI benefits enabled unemployed individuals to remain above the poverty line. In so doing, we subtracted the dollar amount of the UI benefits from family income, determined the family's poverty status, and recalculated the poverty rate. We determined that, in 1990, less than 30 percent of the difference in poverty rates for UI recipients as compared with nonrecipients was due to the benefits, and more than 70 percent was due to differences in hours worked, weeks worked, wages earned, occupation, and other factors.<sup>1</sup> For example, in 1990, unemployed male heads of household who were not UI recipients and counting only their own income had a 45-percent poverty rate. On the other hand, those who received UI benefits had an 18-percent poverty rate. However, after subtracting the value of UI benefits, these same people would have had a 25-percent poverty rate. This variation represents the difference between recipient and nonrecipient poverty rates due to the UI benefits—about 24 percent of the actual difference between their poverty rates (see table III.1).

**Table III.1: Extent to Which UI Benefits Keep the Unemployed Out of Poverty**

Unemployed male heads of household	Poverty rates		Difference (percentage points)	Difference (percent)
	Actual	Without UI benefits		
UI recipients	18	25	6 <sup>a</sup>	34
Nonrecipients of UI	45	45	0	0
Difference	27	20	6 <sup>a</sup>	24

<sup>a</sup>Discrepancy due to rounding.

The results were similar for female heads of household, as well as for males and females when including all family income.

<sup>1</sup>This analysis describes the effect of UI benefits given actual labor market participation. If the UI benefits were actually unavailable, labor market behavior might have changed, so the analysis cannot be extended to predict changes in poverty levels in the absence of UI.

# Comments From the Department of Labor

U.S. Department of Labor

Assistant Secretary for  
Employment and Training  
Washington, D.C. 20210



JUL 13 1993

Ms. Linda G. Morra  
Director  
Education and Employment Issues  
Human Resources Division  
U.S. General Accounting Office  
441 G Street, N.W.  
Washington, D.C. 20548

Dear Ms. Morra:

In reply to your letter to Secretary Robert Reich requesting comments on the draft General Accounting Office report entitled Unemployment Insurance: Funding Issues and Labor Market Changes Jeopardized Program Objectives, I am enclosing the Department of Labor's response.

The Department appreciates the opportunity to comment on this report.

Sincerely,

  
CAROLYN M. GOLDING  
Acting Assistant Secretary

Enclosure



U.S. Department of Labor  
Response to Draft GAO Report Entitled:

Unemployment Insurance:  
Funding Issues and Labor Market Changes  
Jeopardized Program Objectives

The Department of Labor (DOL) has reviewed the subject report and has several general comments. First, DOL is concerned about the overall quality of the report in terms of its heavy reliance on anecdotal information, exclusion of the impact of certain legislative action, and factual errors. Second, DOL believes that the report's focus on the relevance of the objectives of unemployment insurance (UI), rather than UI as a means to achieving those objectives, is misguided.

As to the quality of the report, DOL believes the researchers failed to make full use of the research already undertaken (as noted in the bibliography) on this issue, and instead relied to a great extent on anecdotal information. This oversight is particularly disconcerting in view of the fact that the author of one of the studies participated in this research effort. Consequently, economic factors causing a decline in reciprocity rates are for the most part not addressed. These factors include the decline in manufacturing employment (mentioned only anecdotally), the decline in unionization, and geographic shifts in unemployment by State and region.

Also, the report ignores the impact that the 1980-81 changes to the extended benefit program may have had on the reciprocity rate. Instead, the report attributes much of the decrease in rates to State solvency problems and State reaction to the 1983 changes in Federal law related to loans, the repayment of loans, and the charging of interest on loans. As clarification on another point, the variance of rates based on State trust fund balances is not a response to the 1983 legislation -- such rate variation has been part of the UI program for years.

Further, the report contains some errors in fact. For example, while it is advantageous to employers for States to have a taxable wage base at least equal to the Federal base, it is not required. Also, beginning in July 1992, the funding of Emergency Unemployment Compensation switched from the UI trust fund to general revenue. With respect to loans, automatic repayment is through a reduction in the 5.4 percent credit, not a penalty tax per se. As to the discussion of poverty rates, it should be pointed out that past UI studies have shown that reducing poverty is a side effect for only a small number of UI recipients. Finally, while not an error, the tables and charts do not include the sources of data.

Appendix IV  
Comments From the Department of Labor

Concerning the discussion of the UI objectives, in a number of instances the writers question the relevance of such objectives, i.e., providing a temporary and partial wage replacement to unemployed workers, and helping to stabilize the economy during recessions. DOL believes that there are few, if any, individuals in the social science field who would argue that these objectives are no longer relevant. DOL suggests that, in fact, the objectives are not jeopardized. What may be jeopardized is the effectiveness as UI as the sole means of achieving the objectives.

If you have any questions regarding the above comments, please contact Lynne Webb at 202-219-5200.

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# Related GAO Products

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Declining UI Reciprocity (GAO/HRD-92-34R, Apr. 28, 1992).

Unemployment Insurance: Adequacy of State Trust Fund Reserves  
(GAO/T-HRD-91-7, Feb. 20, 1991).

Unemployment Insurance: Trust Fund Reserves Inadequate to Meet  
Recession Needs (GAO/HRD-90-124, May 31, 1990).

Unemployment Insurance: Comments on HR. 3896, The Unemployment  
Compensation Reform Act of 1990 (GAO/T-HRD-90-15, Feb. 22, 1990).

Unemployment Insurance: Administrative Funding Likely a Growing  
Problem (GAO/T-HRD-89-21, May 24, 1989).

Unemployment Insurance: Administrative Funding Is a Growing Problem  
for State Programs (GAO/HRD-89-72BR, May 24, 1989).

Unemployment Insurance: Trust Fund Reserves Inadequate (GAO/HRD-88-55,  
Sept. 26, 1988).

Unemployment Insurance: Issues Related to Reserve Adequacy and Trust  
Fund Solvency (GAO/T-HRD-88-23, July 7, 1988).

Unemployment Insurance: Issues Related to Reserve Adequacy and Trust  
Fund Solvency (GAO/T-HRD-88-6, Dec. 14, 1987).

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