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UNEMPLOYMENT INSURANCE: Adequacy of State Trust Fund Reserves

Statement of Lawrence H. Thompson
Assistant Comptroller General
Human Resources Division

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Committee on Ways and Means
House of Representatives

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SUMMARY OF TESTIMONY BY LAWRENCE H. THOMPSON
ASSISTANT COMPTROLLER GENERAL FOR HUMAN RESOURCES PROGRAMS
ON
THE UNEMPLOYMENT INSURANCE SYSTEM

The Unemployment Insurance (UI) system provides income maintenace assistance to the unemployed financed thruogh federal and state employer taxes. The system was based on the principle that reserves would be accumulated during economic upturns to pay benefits during periods of declining economic activity; in other words, benefits would be forward funded.

FORWARD FUNDING PRINCIPLE ERODED Recently, the increased reliance on loans and general fund advances has eroded the forward funding principle. For 9 consecutive years, between 1976 and 1984, the UI system operated with a negative net balance. Policy changes by the Congress in the 1980s to foster solvency expedited state loan repayments but resulted in increased UI taxes and reduced access to benefits by unemployed workers. As a result, the proportion of the unemployed receiving benefits has declined from about one-half in 1975 to one-third in the 1980s.

CURRENT RESERVES APPEAR INADEQUATE State trust fund reserves have increased substantially in the past 8 years of economic expansion to $39.6 billion, yet, this is only equivalent to about 11 months in recession-level benefits. Department of Labor projections, using Office of Management and Budget assumptions, indicate that 9 state trust funds will become insolvent due to the current recession. Using more pessimistic assumptions, simulation results show that 12 states would become insolvent.

IMPLICATIONS OF INADEQUATE TRUST FUND BALANCES Current UI policies encourage states to maintain trust fund solvency, but do not encourage states to build adequate trust fund reserves. During the 1980s, when many state trust funds became insolvent, states raised taxes and cut benefits to repay loans. If states must borrow during the current recession, they are likely to take similar actions. These actions are in direct opposition to the objectives of the UI system and further erode its effectiveness. The key issue facing the UI system, therefore, is how to insure that states use periods of economic expansion to build adequate trust fund reserves while providing adequate benefits to unemployed workers.

Mr. Chairman and Members of the Subcommittee:

I am pleased to be here today to share with you some results from GAO's analysis of issues facing the federal-state Unemployment Insurance (UI) system. Specifically, I will discuss (1) the general trend in the financial health of state trust funds over the last 20 years, particularly the trend away from operating on a forward funded basis; (2) the actions taken by states during the 1980s in response to recessionary conditions and new federal loan policies; and (3) the potential effect of the current recession on the federal and state UI accounts. In summary:

-- There has been a long-term decline in the adequacy of state trust fund reserves.

-- This decline led to massive borrowing by insolvent state trust funds in the 1980s to pay benefits.

-- In an effort to regain solvency, states raised employer taxes and limited the growth in expenditures by reducing benefit duration and tightening eligibility requirements. These steps greatly diminished the effectiveness of unemployment insurance as a countercyclical economic stabilizer and undermined its effectiveness as a source of income replacement for the unemployed.

-- If the current recession lasts longer or is more severe than anticipated, it is likely to again result in many states becoming insolvent and having to rely on federal loans to pay benefits. This, in turn, could result in state actions similar to those taken in the 1980s, further diminishing the program's effectiveness.

The primary purposes of the UI system are to provide the unemployed with a temporary source of income as well as to act as an economic stimulus during periods of economic decline. It is our view that, in order to avoid further erosion of these purposes, the principle of forward funding needs to be adhered to

more fully, meaning that states need to build and maintain adequate trust fund reserves during prosperous times. Our previous reports[1] discussed similar issues in much greater detail. Before elaborating on these points, I would like to provide some background on the UI system.

BACKGROUND

The UI system is the federal government's major means of providing income maintenance assistance to the unemployed. The system's primary objectives are to (1) provide individuals with temporary and partial wage replacement when they have lost their jobs and (2) assist in the countercyclical stabilization of the national economy during economic downturns by maintaining the purchasing power of the unemployed. The UI system is operated as a partnership between the federal government and the states and provides for the payment of regular benefits as well as extended benefits during periods of high unemployment. The federal government levies a payroll tax on employers and uses the proceeds to finance both state and federal UI program administration, pay one-half of the extended benefits program, and create a fund from which loans can be made to states with insolvent UI accounts.

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[1] Unemployment Insurance: Trust Fund Reserves Inadequate(GAO/HRD-88-55, Sept. 26,1988) and Unemployment Insurance: Trust Fund Reserves Inadequate to Meet Recession Needs (GAO/HRD 90-124, May 31, 1990).

Each state operates its own UI program, levying and collecting its own payroll tax and, within certain limits, determining the level of benefits and the conditions for benefit eligibility. As a result, tax rates, benefit levels, and trust fund balances vary across states, reflecting variations in program decisions and economic conditions.

The gross federal tax rate is 6.2 percent on the first $7,000 paid annually by employers to each employee. However, if a state meets certain federal requirements and has no delinquent federal loans, 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 establish a taxable wage base for state UI taxes at least equal to the federal taxable wage base--currently $7,000. All states have done this, and 36 states have adopted wage bases above the federally mandated level, ranging from $7,100 in Connecticut to $21,300 in Alaska.

The net federal tax rate of 0.8 percent is made up of a permanent tax of 0.6 percent and a temporary surtax of 0.2 percent. The surtax was added in 1976 to help the system repay loans from the federal general fund. The surtax was extended in 1987 and again in 1990; it is scheduled to expire at the end of 1995.

FORWARD FUNDING PRINCIPLE OF UI SYSTEM HAS BEEN ERODED

The UI program was originally operated on the basis that benefit liabilities would be forward funded. That is, tax rates and benefit levels were set so that the system accumulated reserves during periods of rising economic activity in order to have a reserve sufficient to cover benefit payments during periods of declining activity. This approach was maintained during the first three decades following the program's inception in 1935. Since that time, however, states' actions have led to a gradual erosion of the forward funding principle. Many states have failed to maintain sufficient reserves, relying instead on federal loans to continue paying benefits during economic downturns.

In 1944, the Congress first established a loan account to provide loans to states with trust fund balances below a specified level, but this authorization was allowed to expire in 1952 because no state ever became eligible. In 1954, new legislation was enacted to again make loans available to the states and this authorization remains in effect today. Initially, federal loans were interest free, but in 1981 the Congress enacted legislation that established an interest charge of up to 10 percent on loans not repaid within the fiscal year they were borrowed.

While federal loan authority provided the advantage of assuring that benefits would continue to be paid even if state trust funds were depleted, it eventually led to the

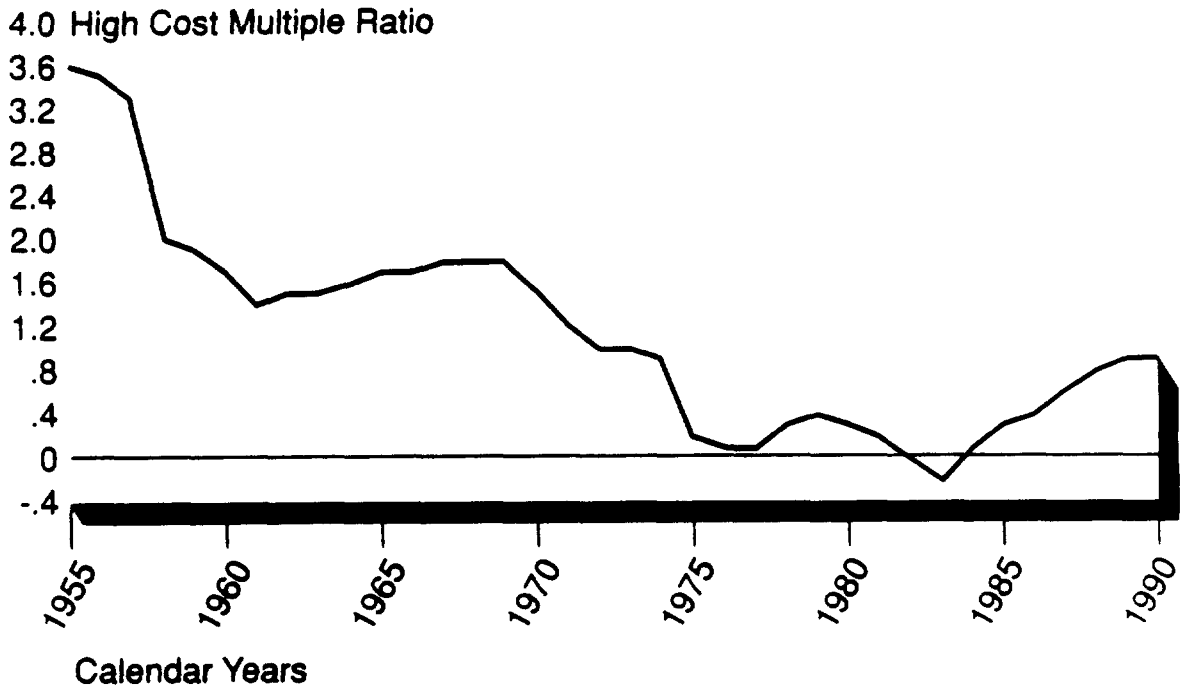
undercutting of state fiscal discipline. Little use was made of the loan account until the 1970s. Before that time, only three state funds ever received federal loans, and only one fund was ever insolvent at the end of a calendar year. Since then, however, state reliance on federal loans to sustain benefits has 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.

Another way to trace the evolution of increased state reliance on federal loans and the departure from a forward funded program is illustrated by the trend in the high-cost multiple. The high-cost multiple is the most commonly used indicator of how long recession-level benefits could be paid from current reserve balances. The Interstate Conference of Employment Security Agencies has endorsed a standard high-cost multiple of 1.5 as being indicative of reserve adequacy. This means that trust fund reserves should be sufficient to pay recession-level benefits for 1-1/2 years. Others have endorsed a lower standard of 1.0, meaning reserves equal to a year of recession-level benefits.

The high-cost multiple of the overall UI system (all 53 programs taken together) has declined steadily since the mid-1950s (see fig. 1). Between 1955 and 1969, the high-cost multiple averaged 2.1, indicating a strong financial position, but fell rather steadily during the 1970s and was actually

negative in 1982 and 1983. It has since increased to 0.91 as of September 30, 1990, meaning that, on average, reserves were sufficient to pay about 11 months of recession-level benefits.

Figure 1



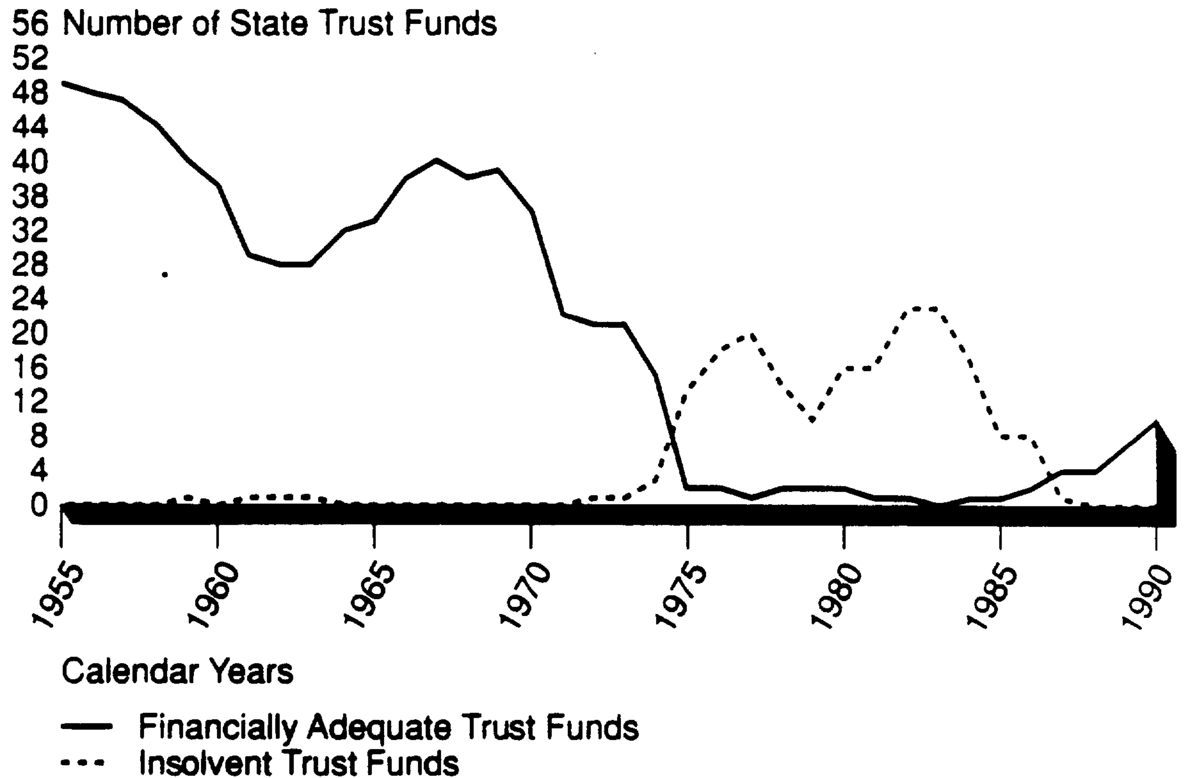
As the high-cost multiple for the overall UI system has declined, so too has the number of states that are maintaining adequate trust fund reserves. And the failure to maintain adequate reserves has increased the frequency of funds becoming

insolvent during periods of high benefit expenditures (see fig. 2). 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 standard has steadily declined to none in 1983 and, at the same time, 23 states were insolvent.

Since 1985, as a result of the longest post-war period of economic expansion, the financial status of the UI system has improved. At the end of fiscal year 1990, the federal accounts totalled $11.7 billion and the state accounts $39.6 billion. However, in our opinion, UI trust fund reserves continue to be inadequate to handle a recession. At the end of fiscal year 1990, 10 of the 53 UI programs had a high cost multiple at or above the 1.5 standard, compared with 39 states in 1969. Using a less stringent standard of 1.0 would only add an additional 16 states to the list of those with sufficient reserves. In contrast, virtually all state trust funds surpassed the 1.0 standard in 1969.

Figure 2

GAO Financial Condition of State UI Trust Funds (1955-1990)



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 major recessions during the last 20 years and increases in benefit expenditures resulting from the creation of the extended benefits program that was not funded by additional state revenues. In addition, the regional

competition for new investment and jobs may be encouraging states to keep UI taxes as low as possible, as a way to improve a state's general business climate. Thus, adequate reserves are not accumulated, even when loans are paid off and the economy is expanding.

THE CURRENT OUTLOOK

In testimony before this Subcommittee on February 6, 1991, the Director, Unemployment Insurance Service, Department of Labor, stated that the balances of the federal UI accounts are currently sufficient to handle administrative costs for projected workloads, extended benefit payments, and state trust fund loan requirements. Using the Office of Management and Budget assumptions, the Labor Department's state loan model[2] projects that a total of 10 states will need to borrow funds from the federal loan account during fiscal years 1991-1995. Nine of these states will become insolvent at some point in time during that period.

The Administration's projections assume a mild recession of short duration. We hope that they are correct. But the actual outcome is uncertain at this time and the financial status of the system is quite sensitive to the economic conditions. To illustrate, we asked Labor to use their model to make projections

[2]This model produces fiscal year estimates of aggregate trust fund balances, loans and repayments, loan balances, reduced federal UI tax credits, interest earnings, and interest paid. State-by-state estimates are also produced, but these are less reliable than the national estimates.

based on different economic assumptions. Specifically, we asked them to assume a longer and deeper recession by projecting the unemployment rate peak at 9 percent rather than 6.9 percent. This simulation showed that instead of 9, 12 state programs could become insolvent at some time between 1991 and 1995, necessitating borrowing from the federal loan account of about $12.9 billion (see table 1). At the end of fiscal year 1995, these states would still owe about $10.4 billion using the more pessimistic assumptions as compared to $8.2 billion using the administration's.

The simulation also showed that the recession we assumed would cause loans to exceed the capacity of the federal loan account. Although the loan account had a balance of $2.2 billion at the start of 1991, it would need an advance of $1.3 billion from the general fund to cover state loans.

Table 1: Effect of Recession on UI Trust Fund Using GAO and OMB Assumptions (Fiscal Years 1991-95)

Dollars in billions	GAO	OMB
State borrowing	$12.9	$9.5
General fund advance to loan account	1.3	0
State loan balances, end of 1995	10.4	8.2
Net state UI balances, end of 1995	39.2	42.3
Insolvent States	12	9

IMPLICATIONS OF INADEQUATE TRUST FUND BALANCES

In the past, concern over increased borrowing has led the Congress to take action to move the system toward a positive total reserve balance. The Congress enacted several policy changes in the late 1970s and early 1980s that, in essence, made it more expensive for states to deplete their fund balances and borrow from the federal government. These actions included

-- charging states interest on federal loans if not repaid in the same fiscal year as borrowed;

-- enforcing a penalty tax on employers in states with delinquent loans; and

-- providing federal loan interest deferrals, discounted loan interest rates, and partial freezes on employer penalty taxes if states made progress toward restoring trust fund solvency by cutting benefit costs and increasing taxes.

In response to these policy changes, many states increased employers' UI taxes and substantially increased loan repayments. However, state actions also resulted in a decrease in the proportion of the unemployed population receiving benefits by reducing the duration of benefits, tightening eligibility standards, and increasing penalties for benefit disqualification.[3] For example, in 1975 over 50 percent of the total unemployed population received benefits, whereas during the

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[3]All states disqualify benefit claimants who quit their jobs without just cause, were fired for misconduct, or refused suitable employment. Penalties for claimant disqualification often specify a duration of benefit ineligibility and an additional earnings requirement for requalification.

past 10 years an average of 33 percent received benefits. We noted in a previous report[4] that:

-- since 1981, six of eight states that paid benefits for periods longer than 26 weeks, cut them back to the 26-week maximum used by other states;

-- 35 states increased the earnings level required for minimum weekly benefits, while 18 states changed their earnings distribution formula in such a way as to reduce the number of unemployed eligible for benefits; and

-- 19 states increased the disqualification penalties for claimants who quit work without good cause, 22 states increased penalties for claimants dismissed because of misconduct, and 20 states increased penalties for claimants who refused suitable work while unemployed.

A 1988 study,[5] prepared for the Department of Labor estimated that changes in state UI laws and administrative practices accounted for between 30 and 40 percent of the decline in the proportion of the unemployed receiving benefits between 1980 and 1986.

Given the inadequate reserve levels in many states, the current recession could result in another round of state benefit cuts and employer tax increases as the states work to expedite loan repayments. While the impact on the federal budget deficit would be favorable, it is uncertain this would be the most desirable public policy. If instituted before the economic recovery begins, payroll tax increases and benefit reductions may delay recovery by discouraging increased hiring and reducing

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

[5] An Examination of Declining UI Claims During the 1980s: Draft Final Report(Mathematica Policy Research, Inc., May 1988).

consumer spending. Moreover, more benefit cuts could further reduce benefit adequacy. The sum total of all this would be a reduction in the UI program's ability to carry out its intended purpose of helping Americans who have lost their jobs through no fault of their own.

In conclusion, the current UI policies encourage state trust fund solvency but not trust fund adequacy. The charging of interest on loans encourages states to get out of debt, but no policies encourage them to build reserves to handle future recessions. Once insolvent states pay off their loans, employer tax rates are frequently reduced and reserve accumulation is slowed before reserves reach levels adequate to restore the forward funding principle to the Unemployment Insurance program. The key issue, therefore, facing the UI system is how to insure that states use periods of economic expansion to build and maintain adequate reserves while providing adequate benefits to unemployed workers.

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Mr. Chairman, that ends my prepared remarks. I will be happy to address any questions that you or other Members of the Subcommittee may have.

QUARTERLY UNEMPLOYMENT RATES
UNDERLYING UI TRUST FUND SIMULATIONS

Fiscal Year	Quarter	OMB Assumptions	GAO Assumptions
1991	1	5.9	5.9
	2	6.8	6.8
	3	6.9	7.6
	4	6.8	8.3
1992	1	6.7	9.0
	2	6.7	8.7
	3	6.7	8.4
	4	6.7	7.9
1993	1	6.6	7.4
	2	6.5	6.9
	3	6.4	6.4
	4	6.2	6.2
1994	1	6.1	6.1
	2	6.0	6.0
	3	5.9	5.9
	4	5.9	5.9
1995	1	5.8	5.8
	2	5.7	5.7
	3	5.6	5.6
	4	5.4	5.4