The unemployment insurance system: its financial structure

Since the early 1970's, there has been a departure from the past exclusive reliance on employer taxes to pay for benefits; a built-up Federal role and the advent of new benefit programs have replaced it

ARTHUR PADILLA

The current Federal-State system of unemployment insurance (UI) traces its origins to the Social Security Act and related laws of 1935. The clear expectation of the Congress and of President Roosevelt was that this legislation would lead to the creation of State UI programs broadly compatible with Federal law. This anticipation was based in part on the economic incentives inherent in the act, whereby employers who paid taxes to a Federally approved State UI program would be exempt from most of the Federal unemployment payroll tax.[1]

Today there are UI programs in the 50 States, the District of Columbia, Puerto Rico, and the Virgin Islands, each providing compensation in accordance with its own benefit standards.[2] These 53 systems cover 90 percent of all employers and 95 percent of all wage and salary employers. To fund the programs, States tax employers at rates which reflect, to varying degrees, the employer's record in laying off workers. Employers with relatively favorable histories in worker layoffs will therefore pay lower payroll taxes than other firms.

Over the years, the financing of regular UI benefits has been based on the concept of individual employer responsibility for the insurance costs of unemployment. In an important sense, the costs of unemployment benefits have been treated for nearly half a century as another expense of doing business.

Employers absorb fewer costs

Since the early 1970's, the UI system has depended less and less on State employer taxes to pay for benefits, thus weakening the relation between previous work and earnings on the one hand and insurance benefits on the other. The initiation of the extended benefits program in 1970 and of the Federal supplemental benefits program in 1974 signaled the beginning of a significant Federal role. These nonregular programs, which basically extend the time during which benefits may be collected, have resulted in larger costs and have required the imposition of higher taxes and tax rates on employers. A substantial part of the Federal employer tax is set aside to pay for half of the costs of the extended benefits program; States pay for the other half from their own payroll taxes. General U.S. Treasury revenues, as well as the Federal payroll tax, financed the now-expired supplemental benefits program during its 4-year duration.[3]

Beyond its increasingly important position in financing extensions of unemployment benefits, the Federal Government performs another related role. When a State's UI reserves are depleted (either because the level of benefits it awards is too high in relation to its tax receipts or because it has endured relatively steep unemployment rates over time), that State may borrow

Arthur Padilla is associate vice president for academic affairs at The University of North Carolina system. This article is based on a study done while the author was on the staff of the Brookings Institution.

interest-free Federal funds to meet its benefit obligations.

The 1974–75 recession, longest since World War II and following closely the severe recession of 1970, painfully underscored the financial weaknesses of many State UI programs. About half of the State systems exhausted their reserves and were forced to take interest-free advances as a direct result of the mid–1970's downturn and, as of March 1981, 17 States continued to owe nearly $6 billion in outstanding loans.[4] In addition to this *State* debt, the expansion of nonregular benefits (extended benefits, supplemental benefits, and other programs) during the 1970's resulted in a large *Federal* debt, still outstanding. The Federal share of the debt in the extended benefits program is currently about $1.8 billion, and an additional $5.8 billion is due the Treasury for costs of the supplemental benefits program.

The following section describes, in general terms, the complex financial structure of the UI program. It will serve as a preface to later discussions about problems of the State trust funds, the pursuant debts of many States, and other immediate and longer-term issues.

Current financial conditions

The existing financial structure of the UI system is extremely complicated. Employer taxes as well as general U.S. Treasury revenues flow through a perplexing maze of trust funds and special accounts to pay for loans to States, regular benefits, extended benefits, and other special UI programs such as Public Service Employment, trade readjustment allowances, and unemployment compensation for Federal employees. Originally, the employer taxes went to the State trust funds to pay for the regular benefits, and to the Employment Security Administration Account to cover State and Federal costs of operating the program.

Specifically, Title IX of the Social Security Act established the Unemployment Trust Fund in the U.S. Treasury to hold receipts from Federal and State UI taxes. There are separate accounts within the fund for each of the States, as well as three distinct Federal accounts. The Federal accounts are the Employment Security Administration Account, the Extended Unemployment Compensation Account, and the Federal Unemployment Account.

The current Federal unemployment tax rate is 3.4 percent of the first $6,000 of each employee's annual wages and employers receive credit for 2.7 percentage points of the tax, if they operate in a State with an approved UI system.[5] The remainder (0.7 percentage points) is distributed between the employment security account (0.45 percentage points) and the extended compensation account (0.25 percentage points). As previously indicated, the former pays all administrative expenses, both Federal and State, while the latter funds half of extended benefits and all of the Federal supplemental benefits (which expired in 1978). The State trust funds pay for 100 percent of the regular benefits and for the other half of the extended benefits.

It is important to observe that general revenues also are funneled into the extended compensation account and the Federal account. The latter account serves the critical function of providing repayable interest-free advances to States with depleted reserves, and with 17 States currently devoid of any reserves, this aspect of UI financing is significant. Any excess of payroll tax receipts remaining after payment of State and Federal administrative costs is directed by law to this account, which has a statutory ceiling of 0.125 percent of total wages in covered employment (currently about $1.2 billion). If either account is depleted, congressional appropriations from general revenues are necessary. These appropriations from Treasury funds are actually loans without interest which by law must be repaid either from direct State repayments of outstanding loans or from increases in the Federal payroll tax through reduced employer credits.

The 17 States with outstanding loan balances as of March 1981 are shown in table 1. The total unpaid amount is $5.926 billion, with five States (Illinois, Michigan, New Jersey, Ohio, and Pennsylvania) accounting for three-fourths of the debt. Illinois and Pennsylvania each owe sums which exceed the statutory limit of approximately $1.2 billion in the Federal account, the fund used to provide loans to all States with depleted reserves. Most of these debtor states have owed for 6 years or more. Why is it that so many States owe significant sums to the Federal account and are, in effect, being subsidized by nondebtor States? This article will now analyze the *State* debt to the Federal account and then review the *Federal* debt to the extended compensation account.

Table 1. States with outstanding Federal loan balances as of March 1981, and date loans were first made

State	Amount outstanding	Date of loan
Total	$5,936,386,940	
Arkansas	62,500,000	January 1976
Connecticut [1]	368,776,887	March 1972
Delaware [1]	49,332,893	November 1975
District of Columbia [1]	59,302,145	November 1975
Illinois [1]	1,280,770,410	December 1975
Kentucky	30,000,000	February 1981
Maine [1]	36,169,356	September 1975
Michigan	886,000,000	April 1975
Minnesota	99,800,000	April 1975
New Jersey [1]	659,127,836	January 1975
Ohio	520,933,000	March 1977
Pennsylvania [1]	1,530,814,839	October 1975
Puerto Rico [1]	84,425,098	April 1975
Rhode Island [1]	120,880,971	February 1975
Vermont [1]	40,597,195	February 1974
Virgin Islands [1]	7,142,310	February 1975
West Virginia	99,814,000	September 1980

[1] State making repayments through reduced employer credits toward Federal taxes.

The Federal account and State debt

As early as 1939, an excess of payroll tax receipts over unemployment benefits paid was apparent and year-end reserves in State trust funds were rising rapidly. Between 1943 and 1946, benefit payments as a percentage of total wages were extremely low. As a result, reserves in State trust funds reached 10.4 percent of total wages in 1945 and 9.4 percent in 1946, levels never again experienced in the reserve-to-wages ratio. Moreover, from 1946 to 1953, costs continued to fall in relation to contributions, and States steadily cut payroll tax rates to reduce the large surpluses in their accounts. (These trends in UI financial measures expressed as a percentage of total and taxable wages are presented in table 2.)

The "supersolvency" period ended during the 1957–58 recession, as the benefit costs ratio (that is, the ratio of expenditures on benefits to total wages in covered employment) rose to approximately double that for the preceding years. Since then, year-end reserves as a percentage of total wages (the reserve ratio) have remained below about 3.5 percent. Low benefit expenditures were experienced in the mid- and late 1960's and the slight decline in year-end reserves which began in the late 1950's as a result of a rise in unemployment was arrested. The reserve ratio, as seen in table 2, stayed between 3 and 3.5 percent of total payrolls during the 1960's. However, the downturn in 1970-71 dampened optimism about the continued solvency of many State UI systems. Even though the benefit cost ratio during this recession was relatively modest (in comparison to 1958) at approximately 1.2 percent of covered payrolls, reserves had fallen to 2.1 percent of total wages by the end of 1972. More importantly, a few States with unexpectedly high benefit costs had to borrow large sums from the loan fund to meet liabilities during 1972–74.

Reasons for State financial distress. Insolvency in State UI systems, a situation in which accumulated net reserves and current payroll tax receipts do not meet current benefit costs, became a noticeable problem in a few States during the early 1970's. However, it was not until 1975 that State insolvency reached the current acute stage. From 1972 to 1974, only three States received interest-free advances from the system, while in 1975 and 1976, 23 States had outstanding loans. Throughout the 1970's, 26 different UI systems received advances. While it is beyond the scope of this article to delve into State-by-State detail on the particular causes of insolvency, it will be useful to discuss certain factors which apparently have contributed significantly to the problem.

The incidence of unemployment has accelerated in recent years, and some States have been disproportionately affected. Considering States which had outstanding loan balances in early 1981 ("debtor" States), it is clear that their unemployment rates have been significantly higher than those in "nondebtor" States. In addition, the "trigger" for extended benefits has been more likely to come on and stay on in the debtor States than in others (that is, insured unemployment rates of debtor States are more apt to be above the 4-percent extended benefits "trigger" than are those of nondebtor States). For instance, during fiscal 1979 and 1980, States with outstanding balances were paying for extended benefits an average of 8 months per year, compared to approximately 4 months for the other two-thirds of the country. The adverse economic conditions present during the 1970's have affected all State UI systems, but the debtor States apparently have experienced more severe economic conditions.

Another important consideration is the degree to which insolvent States are responsible for their financial plight. In particular, it has been suggested that the Federally mandated extension of benefits (both the extended and supplemental benefits programs) contributed to the very high costs which some States experienced during the 1974–75 recession. First, it should be noted that the supplemental benefits program was always exclusively a Federal program, and thus never added a financial burden to State systems. Second, while the existence of extended benefits may lengthen the duration of unemployment and raise program costs slightly, regular UI benefits have historically exceeded by very large margins the costs associated with the extended benefits program. The costs of the State share of this program do not go very far in explaining the depletion of reserves among debtor States; only during 1975 and 1976 were extended benefits costs more than 5 percent of to-

Table 2. Trends in unemployment insurance financial measures, selected years, 1940–78

Year	Percent of total wages			Average employer tax rate (percent of taxable wages)	Reserve ratio (percent of total wages)	Reserve multiple ratio[1]	
	Taxes collected	Benefit costs	Average employer tax rate			Actual	High cost
1940	2.63	1.60	2.50	2.70	5.60	3.50	....
1945	1.74	.67	1.50	1.71	10.38	15.49	....
1950	1.16	1.33	1.18	1.50	6.76	5.08	....
1955	.81	.91	.81	1.18	5.56	6.11	....
1960	1.17	1.40	1.15	1.88	3.29	2.35	1.60
1965	1.18	.84	1.18	2.12	3.17	3.77	1.55
1970	.65	1.01	.64	1.34	3.11	3.08	1.51
1974	.94	1.07	.94	2.00	1.88	1.75	.92
1975	.90	2.03	.89	1.98	.53	.26	.24
1976	1.16	1.39	1.20	2.58	.13	.09	.06
1977	1.27	1.16	1.29	2.85	.13	.11	.06
1978	1.35	.93	1.37	2.77	.55	.60	.25

[1] Reserve multiple ratio (actual) = reserve ratio/benefit costs ratio, and reserve multiple ratio (high cost) = reserve ratio/1958 benefit ratio or reserve ratio/1975 benefit ratio. (The "high cost" multiple ratio is one measure of fiscal solvency, with 1.5 considered a minimum level of reserve adequacy. The "high cost" years are 1958 and 1975.)

SOURCE: U.S. Department of Labor, Employment and Training Administration, Unemployment Insurance Service.

tal costs. Indeed, comparison of payroll tax receipts with benefit expenditures shows that debtor States generally lacked tax revenues necessary to meet even *regular* UI benefit costs during the mid- and late 1970's.

The evidence further shows that relative taxing efforts, in absolute terms and in comparison to total wages, of debtor States are not as high as might be expected given their costs. In 1978, about half had an average employer tax rate as a percent of taxable wages of 2.8 percent (the national average) or more, and 1978, it is noted, follows several years of continued insolvency for these States. Some debtor States did experience soaring costs during the mid-1970's which obviously contributed to their indebtedness. However, the problem in some States (for example, Michigan and Connecticut) appears to be related to a policy of maintaining relatively low reserves in comparison to payrolls and of continuing to impose tax rates well below those of other States with comparable costs. In contrast, others (such as North and South Carolina) had very high increases in costs during 1975 but did not go into debt because they entered the recession with very high reserves, and some (for example, California) survived the escalated costs by raising payroll taxes as the economy worsened. It should be underscored that these uneven financing patterns among States lend little support for a Federal policy of loan forgiveness, because of the inequities such a solution would create among solvent and debtor States.

Possible solutions to the problem. Hindsight suggests that more fiscally prudent reserve levels in debtor States might have been helpful in avoiding insolvency. In the past, several solvency standards or rules have been suggested to ensure that States would have sufficient funds to meet yearly program costs without creating vast surpluses or large deficits in reserve funds. The "reserve multiple" rule is the one most often recommended and the Department of Labor generally urges States to adapt it to their own cost experiences.[6] However, simple arithmetic shows that use of the standard of the 1.5 reserve multiple ratio (that is, a value of at least 1.5 for the reserve ratio divided by the high cost ratio) in reserves at the start of 1970 would not have forestalled insolvency in most of the States which experienced it during the 1970's. Indeed, a reserve multiple of 2 would not have been enough in many cases. For one thing, this reserve multiple rule is apparently predicated on there being sufficient time between recessions for adequate reserves to accumulate. Back-to-back recessions such as those of 1970–71 and 1974–75 evidently do not permit this rebuilding without some increase in tax rates. Also, the reserve multiple rule does not account for liberalizations in benefits which have occurred.[7]

The National Commission on Unemployment Compensation, an independent advisory body to Congress and the President, recently provided a set of policy recommendations pertinent to the financing of the UI system. The commission circuitously addressed the issue of outstanding State loans by suggesting that *all* States be "reimbursed from Federal general revenues for the State share of extended benefits costs during the period of the national 'on' trigger," on a retroactive basis. (A related recommendation was that *existing* loans not be required to bear interest in the future.)

Reimbursement of the States for their share of extended benefits costs during the national trigger periods would cost the Federal Government about $3.3 billion. Because most of those monies would be going to nondebtor States, the reduction in the current State debt would amount to $1.3 billion, slightly less than one-third of the $5.9 billion outstanding. Thus, a liability of more than $4.6 billion would remain if the recommendation were accepted. The merits of this recommendation seem to relate to the propositions that all States should be treated equally, and that cutting back the debt from $5.9 to $4.6 billion would somehow provide a fresh start in solving long-term problems. It may also be an implicit recognition of the disparate impact that the 1975 recession had among States. On the other hand, the recommendation does not address the issue of the remaining State debt and sets a significant precedent in forgiving repayment of sizable sums. It further raises the issue of equity in the treatment of States which have not borrowed or which have borrowed but have repaid their debts, and those which have yet to repay substantial loans. Therefore, in terms of fairness to nondebtor States, it would be preferable not to dismiss any of the debt. Loan policy should also be modified to begin charging interest for any outstanding loan balances, to prevent the implicit subsidy going from nondebtor to debtor States. The current debt is costing (conservatively) about $600 million in forgone interest, an expense being met by employers and taxpayers in nondebtor States.

The Federal side

In addition to the $5.9 billion owed by 17 States to the Federal Unemployment Account, there is also a Federal debt due the Extended Unemployment Compensation Account, which at the end of 1980 amounted to $7.6 billion. Therefore, the combined total debt for the UI system is more than $13.5 billion.

The current Federal debt to the extended compensation account consists of $1.8 billion for the extended benefit program and $5.8 billion for the Federal supplemental benefit program, which expired in 1978. As noted earlier, funds from the Federal Unemployment Tax Account (FUTA) are used to finance all administrative costs in the UI system, as well as the Federal share of extended and supplemental benefits costs. Before 1977, the FUTA tax was 0.5 percent of covered wages, and 90 percent of that (or 0.45 percentage points) flowed into the Employment Security Administration Account to cover administrative costs. The remaining 0.05 percentage points paid for the Federal share of the extended benefits through the extended compensation account fund, which explains why the Federal debt rose so rapidly between 1970 and 1977.

In 1977, Congress recognized that the 0.05 percent could not meet the mounting costs of the additional unemployment benefits programs it had established, and the FUTA tax rate was raised to 0.7 percent. The portion of the Federal tax designated for administrative expenses remained at 0.45 percent while the percentage designed to pay the extended and supplemental benefits rose from 0.05 to 0.25. This last figure is currently being used to retire (slowly) the existing Federal debt, although if an unemployment increase should retrigger the extended benefits program, the funds would then be used purely for paying current expenses. And, if those costs should exceed the amount which the 0.25-percent tax generates, additional borrowing from general revenues would occur and the Federal share of the debt would grow once again.

The present statutory limit of the extended compensation account is 0.125 of total wages in covered employment, or about $1.2 billion. After the outstanding indebtedness of this account has been repaid to general revenues, the 0.7-percent net tax will again drop to 0.5 percent. One-tenth of net collections, or 0.05 percent would flow into the extended compensation account to rebuild it; the remaining 0.45 percent would continue to go into the extended compensation account to cover administrative costs; and the total Federal unemployment tax would thus be reduced from 3.4 to 3.2 percent.

Even if the unemployment rate remained at a level below that which would trigger the extended benefits program, the extended compensation account would not be replenished very rapidly after its debt to general revenues is finally paid off.[8] Back-to-back recessions, such as those in the 1970's, or periods of sustained high unemployment, would quickly deplete its reserves and again require borrowing from general revenues.

The supplemental benefits program, as noted above, was enacted in December 1974, to provide "emergency" supplemental benefits for persons who had exhausted both their regular and extended benefits. The Federal tax receipts flowing into the extended compensation account did not begin to meet the high costs associated with the nonregular programs, and advances to the account from general Treasury revenues were required. The current extended compensation account debt for the supplemental benefits of $5.8 billion must, according to statute, be repaid to the Treasury from receipts of the Federal payroll tax on employers. This debt was incurred from the beginning of the supplemental benefits program through March 1977. Subsequently, supplemental benefits costs were charged directly to general revenues, not to the extended compensation account, thus relieving the States and employers of the costly burden. This practice continued until the program was terminated in 1978.

Congressional authorization to cover costs of the supplemental benefits program from general revenues is tacit acknowledgment that at least some portion of the costs of benefit extension should be borne by taxpayers at large rather than by individual employers. The concept of individual employer responsibility, which is the basis for the States' experience-rated tax systems, makes sense only if employer accountability for unemployment is relatively short-lived. Therefore, any extensions of benefits beyond those that individual States are able and willing to provide should be funded by the Federal Government.

Employers would be relieved of this burden by following another National Commission on Unemployment Compensation recommendation to cancel at least part of this Federal debt. Future depletions of the extended compensation account might also be avoided if the current statutory funding limit of the account were raised to at least 0.25 percent of total wages in covered employment, and provisions made for *automatic* increases in the FUTA tax should reserves in the extended account fall below that fraction. However, any further extension of benefits beyond those of the extended benefits program, such as a new supplemental benefits program, should be paid totally from general revenues. Among other things, general revenue financing would encourage Congress to find the revenues before extending unemployment benefits, something which has not been done previously. This financing arrangement would also be consistent with the principle of limited individual employer responsibility. □

——— *FOOTNOTES* ———

[1] Employers operating in States with approved UI systems originally received a 2.7-percent credit toward the 3.0-percent Federal tax rate. The remaining 0.3 percentage points (or 10 percent of the total Federal rate) was paid by employers to cover all administrative costs of the program. Since 1961, the Federal tax rate has risen to 3.4 percent of taxable wages while the credit has held at 2.7 percent. Thus, the *net* Federal tax rate has increased from 0.3 to 0.7 percent of covered wages.

The current maximum weekly benefits range from a low of $72 in Puerto Rico to a high of $202 in Ohio, with an overall average maximum benefit of about $104 per week. These benefits are not taxable for single individuals with gross incomes of less than $20,000 per year or for married persons filing joint returns with gross incomes below $25,000.

[3] There are other benefit programs which are funded out of general revenues, such as the "Redwood" program for displaced forestry workers in California.

[4] Of these 17 States, 11 were making repayments to the U.S. Treasury through reduced employer credits, as provided in the Federal Unemployment Tax Act. This method of repayment is tantamount to raising the effective tax rates for all employers in the State.

[5] Before 1961, the Federal tax was 3 percent; from 1961–70, 3.1 percent; between 1970 and 1977, 3.2 percent; and, since 1977, it has been 3.4 percent of taxable wages. The total credit allowed to employers in States with approved UI programs has remained at 2.7 percentage points, or nine-tenths of the original 3.0-percent payroll tax.

[6] See Paul Mackin, *Benefit Financing in Unemployment Insurance: A Problem of Balancing Responsibilities* (Kalamazoo, Mich., Upjohn Institute for Employment Research, 1978), pp. 31 ff. The reserve multiple rule suggests that a State's reserve ratio should be 1.5 to 3 times the highest consecutive 12-month benefit costs ratio since 1958. Both types of ratios are expressed as a percentage of total wages in covered employment which adjusts these indices for rising total wages. It is thought that States with reserve multiple ratios of 1.5 would have sufficient funds in reserve (and in current tax receipts) to pay for the increased costs of a recession as severe as the worst experienced since 1958.

[7] Paul Mackin, *Benefit Financing*, pp. 31 ff.

[8] If only 0.05 percent of taxable wages is allowed to flow into the extended compensation account, it would take approximately 6 to 8 years at present wage levels to reach the current statutory limit of the account, assuming no program costs for extended benefits.

Reducing structural unemployment

Unemployment can be said to be structural in nature if aggregate demand is high enough to provide jobs at prevailing wages for everyone seeking work but job openings remain unfilled because of a persistent mismatching of skills or geographical locations. If the mismatching is resolved voluntarily through mutual search by workers and employers in a reasonably short period of time, say 8 or 10 weeks, the resulting unemployment falls in the frictional category. The unemployment becomes structural, however, if the mismatching cannot be resolved by such voluntary action and the job seekers are required to develop new skills or change their place of residence but are effectively precluded from doing so. In the former instance the workers choose to remain unemployed because of the likelihood of finding suitable work, while in the latter their unemployment is involuntary in the sense that they cannot overcome the barriers that bar them from such work.

—FRANK C. PIERSON
The Minimum Level of Unemployment and Public Policy (Kalamazoo, Mich., W. E. Upjohn Institute for Employment Research, 1980), p. 53.
