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Unemployment Insurance: An Old Lesson for the New Federalism?

by Michael F. Bryan

Although the unemployment insurance (UI) system in the United States evolved through the prompting of the federal government, the UI system functions as a collage of 53 individual state programs.[1] The UI system is nearly 50 years old, yet its design might be viewed as a model for the Reagan administration's "New Federalism." As state-managed, state-financed insurance programs, the UI system embodies state autonomy in operating what essentially is *federally* established policy. However, a policy conceived at the federal level is not always cordially received at the state level, particularly if states are expected to shoulder part of the policy's financial burden. In the UI system the financing effort of the state programs has not been uniform, and the federal government has permitted, and even encouraged, some state UI programs to spend beyond their resources.

This *Economic Commentary* discusses the state-federal UI marriage, examines the financial problems that have developed at the state level, and highlights recent changes declared at the federal level to improve the current management of the system.

1. These 53 programs include those of the District of Columbia, Puerto Rico, and the Virgin Islands.

Conflict of Interest

Since its inception, the UI system has been a federal labor policy pressured onto the states. The creation of state-operated unemployment insurance encountered tremendous resistance, because compensation for not working was an unpopular idea in the early industrial years of America. As the industrial sector of the economy grew, the belief that laborers needed financial protection against income losses associated with business cycles gained support. In 1933, 68 unemployment-compensation bills were introduced in 25 states, but all of the bills failed. As part of the Social Security Act of 1935, the federal govern-

Michael F. Bryan is an economic analyst with the Federal Reserve Bank of Cleveland. *The author gratefully acknowledges the comments of Mark S. Sniderman throughout the preparation of this article.*

strained to state-imposed maxima regardless of the experience rating, and because taxes apply to a fixed, state-determined wage base, UI programs tend toward financial insolvency with persistent unemployment increases. UI revenue drains leave legislators with the uncomfortable prospect of increasing employer UI taxes and/or lowering benefit amounts.

The interest-free FUA lending arrangement provided states with an attractive alternative. Politically, it seemed easier for state legislators to have UI program solvency enforced at the federal level via an imposition of FUTA tax-credit losses (an important lesson from TUC in 1958). Economically, the cost of borrowing from FUA was inexpensive, because the loans were interest-free. Debt repayment also could be postponed for a considerable time, ensuring that state debts would be repaid with inflated dollars. Moreover, a net subsidy accrued to borrowing states because states that did not take the difficult path of following UI fiscal solvency forced the Treasury to fund UI payments by increased taxes or debt—costs shared by all states.

As the division between temporary and habitual FUA borrowers became apparent, debate intensified over the appropriate action to be taken against long-term FUA borrowers. The Labor Department regularly urged states to maintain adequate UI reserves. And just as regularly, mandatory UI solvency regulations had been discussed. Other proposed solutions included forgiving state debts, accelerating loss of FUTA credits, and even increasing the federal role in the UI system. Forgiveness was not an equitable solution because of the predominance of states that repaid FUA debts in good faith. Rapidly reducing the FUTA credit for borrowing states was discarded because it might cause further employment loss for borrowing states, either via bankruptcies or employer migration to lesser taxed states. In light of the current administration's focus on New Federalism, further centralization of the UI system is unlikely. Instead, the federal government seems committed to reducing the financial incentives that tend to promote state UI insolvency and enforcement of fiscally responsible state UI management.

The Omnibus Budget Reconciliation Act

In a comprehensive restructuring of the UI system, the Omnibus Budget Reconciliation Act of 1981 (OBR) reinstated the two-year FUA loan pay-back schedule. Outstanding FUA loans beyond the payback period result in a graduated loss of the FUTA tax credit. The OBR also imposed a rate of interest on outstanding advances equal to that earned in nonborrowing state UI trusts. The OBR repealed the national trigger for extended UI coverage, increased state extended-benefits trigger thresholds, changed the method of calculation of state-insured unemployment rates, tightened eligibility requirements of those receiving extended UI benefits, and disqualified recently discharged military personnel from UI coverage if they were eligible for reenlistment.

The FUA interest charge should effectively reduce the subsidy from the federal government to chronically broke state UI programs.[5] While this does not guarantee fiscal solvency for the UI system, these steps mark an important realization that the state-federal UI financial structure is less than ideal. Overall, the changes promote UI financing adjustments at the state level by making it more expensive to transfer the costs to the federal level. The OBR does not, however, appreciably alter what some states perceive as overbearing federal involvement in UI management.

Many states, including Pennsylvania, recently have reformed their UI taxation and benefit provisions. These changes generally are rather modest compared with the enormous debts already incurred. Pennsylvania's reforms, coupled with a reduced FUTA credit that began in late 1981, would not restore financial solvency to its UI program in this decade and possibly not in this century. The growing financial problems of the UI system serve as a useful example of the consequences of weak enforcement of state financial responsibility for policies of predominantly federal origin.

5. Labor Department estimates of UI savings resulting from the OBR exceed $3 billion in the current fiscal year and over $8 billion in the next five years.

A Lesson for the New Federalism?

The underlying premise of the New Federalism is relatively simple: efficient and accountable governmental programs require management that is close to the problem. Specifically, states are better suited to design and operate their public-policy systems than the federal government. Details of the New Federalism are still incomplete, but some of the discussions suggest an outline strikingly similar to that of the UI system. It is likely that the federal programs delegated to the states would, for a time, come with strings attached. It is expected that the federal government would require some benefit minima, or "maintenance of effort," although rigid standards are not widely anticipated. States are expected to administer these federal policies, under federal guidance, until individual programs can stand (or fall) on their own.

Eventually, over 45 federal programs will be handed to the states at an expected federal savings of $30 billion over the next ten years. But, clearly, the states will be forced to raise revenues to support their added responsibilities. If the UI experience is viewed as a guide, the financial effort for these programs is not likely to be uniform across states. States that supported the initiation of many of the public programs would resist the New Federalism. These states are the most likely to lose the subsidy from having public programs that are federally funded. States that found the national policy inconsistent with their own goals probably would applaud the administration's New Federalism. And if the New Federalist doctrine is legislated, as is currently proposed, some states probably would eliminate a substantial share of the delegated programs in the wake of federal disentanglement—a result that is not wholly unexpected, nor is it necessarily undesirable.

However, federal cord cutting is certain to be a drawn-out affair. And, it is entirely possible that widespread cancellations by the states of federally conceived programs would result in a resurrection of federal involvement. Failure to allow the states freedom to design a specific program, even if it resulted in a program's extinction, could create new financial nightmares for the federal government, such as the ones that have become evident in the operation of the UI system.

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ment levied a 3 percent payroll tax, called FUTA, 90 percent of which would be waived for employers operating in states having federally approved unemployment-compensation programs. The credit against the federal tax proved to be an effective coercion, and within months thereafter most states introduced UI programs. The FUTA waiver, or credit, can be manipulated by the Secretary of Labor on a state-by-state basis and remains today as a powerful incentive for state governments to comply with federal UI resolutions.

What (and whose) unemployment-compensation goals does the system serve? Although not widely recognized, the UI system contains elements of income maintenance and redistribution, in addition to its original function as an insurance mechanism.[2] UI income redistribution occurring between industries and across occupations in large part results from program parameters such as maximum-benefit allowances and taxation limits. Inasmuch as most program parameters are legislated autonomously at the state level, income-redistribution goals achieved from a UI program can vary according to a state's design. Many of the intended results of the UI system, at the state level, however, are only partially achieved because of a dominant federal interest in the system. From a federal perspective income maintenance and its associated economic stabilization are clearly prominent UI objectives. Unfortunately, there is no reason to expect that UI priorities conceived at the federal level are supported by all states, but only a plurality of states. Moreover, the federal involvement in the management of UI has become more pervasive over time.

The extended UI benefits programs are a case in point. Most states provide unemployment benefits for a maximum of 26 weeks. In periods of severe labor-market weakness, the federal government has initiated extension of regular state UI benefits. The first extended-benefits program, the one-year Temporary Unemployment Compensation Act of 1958 (TUC), was available to states on a voluntary basis. The cost of the program was to be borne at the state level, although the initial outlays to finance extended-benefits payments came via interest-free loans from the federal government. TUC provisions allowed for one additional week of UI benefits for every two weeks of the original state entitlement up to a thirteen-week maximum. However, only 17 states fully participated in the voluntary extended-benefits program, and it proved difficult to collect $446 million in federal TUC loans to the states. Many of the advances remained outstanding for over a decade, and most of the TUC debts eventually were collected by a reduction of the FUTA credit of employers in debtor states.

To encourage more states to offer extended unemployment compensation during periods of prolonged labor-market decline, the federal government enacted another voluntary version of extended-benefits legislation in 1961, called the Temporary Extended Unemployment Compensation Act (TEUC). The primary difference between TUC and TEUC was that TEUC benefits were funded by federal authority through a 0.4 percent reduction of the FUTA credit for all states. Not surprisingly, every state chose to provide extended benefits at a total program expense of $817 million. The large cost of TEUC and the inefficiency of enacting temporary legislation during each recession has given way to the mandatory extended-benefits program of 1970. When state-insured unemployment rates reach federally determined thresholds, extended benefits are "triggered," or released automatically. Costs of extended benefits currently are shared equally by the state and federal governments.[3] The failure of TUC to generate significant voluntary participation of state-financed extended benefits suggests that many states might not offer these benefits without the threat of losing the FUTA credits for noncompliance with the federal policy.

2. For a thorough discussion of the history and financial issues of the UI system, see Mark S. Sniderman, "Unemployment Insurance: A Case for a Private System," *Economic Review*, Federal Reserve Bank of Cleveland, Winter 1980–81, pp. 19–32.

3. Prior to August 1981, the extended-benefits program was triggered by a national and a state-insured unemployment rate. Triggering at the national level by a rate of 4.5 percent resulted in a mandatory 13-week extension of all state UI benefits, regardless of state unemployment conditions. At the state level, extended benefits were triggered by a state-insured unemployment rate above 5 percent, or 20 percent above the average insured unemployment rate in that state over previous years (at state option). State-triggered programs were effective only for the triggering state up to a 13-week extension of UI benefits. There is no longer a national extended-benefits trigger.

The financial burden to states for providing extended UI benefits is substantial, and it continues as a major source of political friction between the state and federal governments in the management of UI. The flexibility that states have over their UI programs is significantly restricted by federally dictated requirements, such as mandatory extended-benefits durations, minimum levels consistent with regular state benefits, and federal determination of state triggers.

The federal government's increasing influence over UI raises some difficult issues regarding the appropriateness of UI financing originating primarily at the state level. The issues are further complicated by the uncertainty of whether UI should be treated as insurance or as public welfare. The conflicts between the federal and state roles and responsibilities in UI are reflected in the poor financial condition of the system, particularly in the operation of state UI trust accounts in the last decade.

The Financial Crisis of State UI Programs

Most state UI programs became insolvent in the last decade. There is little chance, however, that any state UI program would fail to provide benefits, as insolvent programs are supported by loans from the federal government (see box). Many states have accumulated debts of very large proportions. These state UI trust losses have become an important component of the federal deficit. Based on an unemployment rate assumption of 7.5 percent for FY 1982, net state UI losses were estimated by the Labor Department at $2.7 billion, or 6.4 percent of the unified budget deficit. More recently, a Congressional Budget Office estimate, using an unemployment rate projection of 8.6 percent for FY 1982, projected a state UI loss of slightly more than $8 billion, or 8.1 percent of the budget deficit.

The first instance of extensive state borrowing to support a UI program occurred in 1972. At the unemployment peak of the 1974–75 recession, 25 state UI programs received federal advances to their UI trust accounts. With ensuing recovery came declines in state unemployment and reduced borrowing from the federal loan account (FUA). Although the borrowing guidelines of FUA provide a mandatory repayment of loans within two years, this period was extended an additional five years by the 1975 emergency tax-relief legislation, so that some states would not find the normal pay-back schedule unduly burdensome. Without specific regulation, outstanding FUA loans were held in limbo until last year—due, but without interest expense or an enforceable repayment plan.

During the recovery years (1975–79) a sharp contrast developed in the repayment behavior of borrowing states. Some UI loans were repaid within the required period, possibly from the belief that repayment requirements would be reinstated with penalties. Of the original 25 borrowers, 14 states retired their debts with the Labor Department by 1979; other states, however, made little apparent effort to reduce outstanding UI debts. By year-end 1979, $5.6 billion had been forwarded to state UI programs from the federal government, of which only $1.8 billion had been repaid. Pennsylvania, which was responsible for 20 percent of the total FUA loans between 1972–79, had yet to repay any of its UI debt by year-end 1979. As of April 1982, the state UI programs owed the federal government $7.9 billion. Five states currently have serious UI deficits: Illinois ($1.7 billion), Pennsylvania ($1.7 billion), Michigan ($1.6 billion), Ohio ($1.1 billion), and New Jersey ($0.5 billion). Recent acceleration of unemployment-insurance claims has rekindled a more widespread concern over the adequacy of states' support of UI obligations.

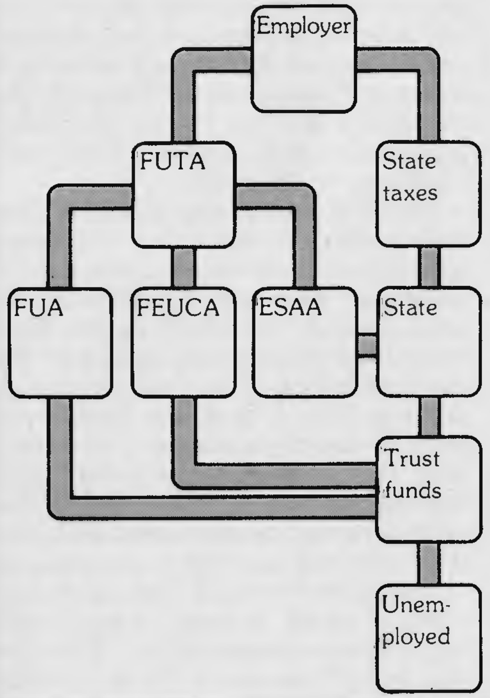
Persistent and high levels of state unemployment increase UI outlays, especially in periods triggering extended unemployment compensation. A high level of unemployment, however, is an insufficient explanation for insolvency over a *prolonged* length of time. UI outlays are a product of benefits per recipient, and the number of eligible recipients—parameters largely within state control—and are not immutably determined by the cyclical component of employment.[4] Given the opportunity presented by federal borrowing provisions, some states have chosen to maintain a prolonged UI outlay/taxation imbalance and delay their FUA repayment obligations to the federal government.

In general, UI solvency problems originate from persistent spells of state unemployment. State UI taxation rates (to some extent) increase automatically with the unemployment rate, although more slowly, as more firms face an increasing incidence of employment separation and a corresponding experience-rating deterioration. Inasmuch as state UI tax rates are con-

4. With an unemployment rate averaging 7.9 percent between 1970–79, California maintained UI financial solvency, without federal aid, throughout even the most severe recession. By comparison, Pennsylvania, with an average unemployment rate of 6.1 percent over the same period, has been functionally insolvent since 1975, and its FUA obligation continues to widen. Despite the higher incidence of unemployment in California from 1970–79, the two states have virtually the same insured, or "covered," unemployment rate (4.5 percent for California, compared with 4.6 percent for Pennsylvania).

Financing the Unemployment Insurance System

The UI system is funded through a dual taxation arrangement, where employers are levied both a state and a federal unemployment tax. State taxes are legislated individually and deposited with the U.S. Treasury in trust accounts. These accounts are interest-bearing deposits with the federal government and are the only source from which regular UI benefits are drawn. State tax rates are determined by a procedure called *experience rating*. Employers with a favorable record of employment separations generally are taxed at a lesser rate than employers with less favorable employment histories. The schedule of rates and number of rating categories vary from state to state. Whereas experience-rating schemes are usually a positive incentive for employers to dampen swings in employment levels, all states provide for a tax-rate minimum, regardless of the firm's unemployment experience.



Most states also provide for a rate minimum, although 13 states have provisions that permit no taxation of the best experienced firms. These experience ratings give the UI system its insurance character, inasmuch as state UI revenues attempt to match the degree of firm unemployment risk with an appropriate rate of taxation.

FUTA is an employer payroll tax earmarked for three federally maintained accounts: the Federal Unemployment Account (FUA), the Employment Security Administration Account (ESAA), and the Federal Extended Unemployment Account (FEUCA). FUA is a loan account for lending funds to states whose trust accounts are inadequate to support regular and extended unemployment benefits. ESAA finances the administrative expenses for state UI programs. FEUCA supports the federal obligation for extended unemployment benefits.