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POLICY BRIEF

States Lack Adequate Unemployment Insurance Reserves

Christopher J. O'Leary

BRIEF HIGHLIGHTS

- *During the Great Recession, 36 states exhausted their unemployment insurance (UI) reserves and had to borrow to pay benefits.*
- *At the end of 2010, the UI system had accumulated $40.2 billion in debt, but by the end of 2018 had recovered to hold over $66 billion in reserves.*
- *Year-end 2018 UI reserves were about 1 percent of total U.S. wages, but this share was 1.9 percent and 1.5 percent before the 1991 and 2001 recessions, and several states still needed to borrow.*
- *If a severe recession started now, it would leave 21 states with combined debt of more than $21 billion; a mild recession would still leave 11 states with UI debt.*
- *Ten of the states forced to borrow in the Great Recession have since cut benefit generosity; two of these would still need to borrow for an average recession.*

For additional details, see the working paper at https://research.upjohn.org/up_workingpapers/321/.

To pay unemployment insurance (UI) benefits to workers who lose their jobs, U.S. states hold reserves in accounts at the U.S. Treasury. When recessions hit, and many workers get laid off, these reserves can be depleted quickly. The Great Recession, for example, exhausted the majority of UI reserve accounts, and not all states have yet adequately replenished them, even more than a decade later. What would happen to balances if another recession were to hit?

To find out, we draw on the patterns of state benefit payments and tax receipts observed over the past 45 years to simulate UI reserve adequacy under the hypothetical case of a mild, moderate, or severe recession emerging in the coming months. Our results suggest that a recession as severe as the average of those occurring since 1974 would cause 18 states to exhaust UI reserves and be forced to borrow to pay regular UI benefits. Notably, our simulations account for the fact that several states have cut benefit generosity since the Great Recession.

Despite federal incentives for forward funding of benefits, the simulations show that UI financing is insufficient in many states. Although state benefit provisions are not excessive by historical standards, state-imposed constraints on the financing system make it slow to recover from debt. Furthermore, state cuts in benefit generosity weaken the automatic countercyclical effects of UI in the aftermath of recessions, possibly slowing future state economic recoveries. These patterns indicate that the UI system is less capable of meeting its intended purpose of partially replacing lost income for unemployed workers between jobs.

Financing UI Benefits: Adequate Reserves Are Key

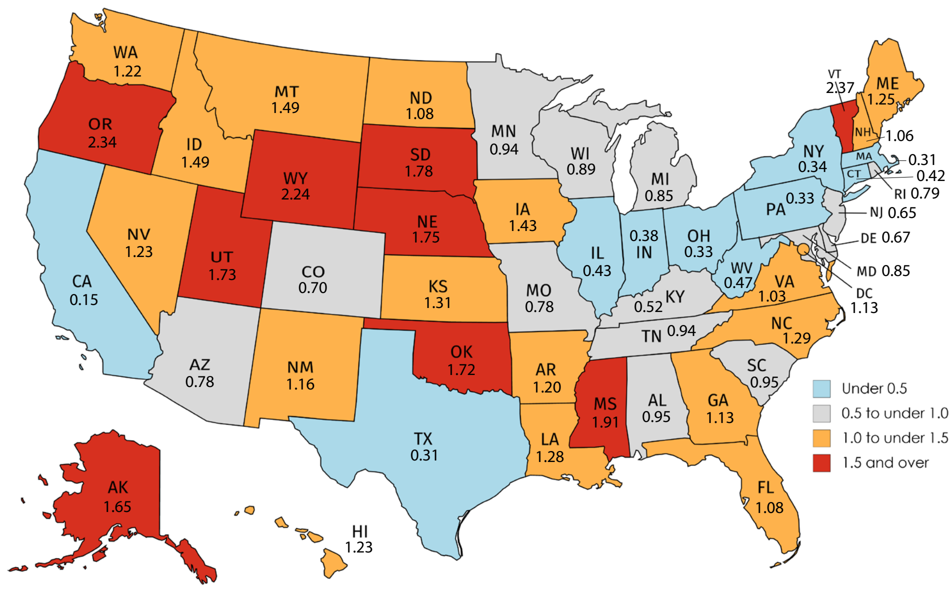
Unemployment insurance benefits are financed by taxes that employers pay on part of the payroll of their employees. The portion of this payroll, called the taxable wage base, varies widely across states, and it can indicate state attitudes toward funding UI benefits. For example, the 2019 UI taxable wage base for each employee is $52,700 in Washington State but only $7,000 in Arizona, California, Florida, and Tennessee. This latter amount of $7,000 represents the minimum set by the Federal Unemployment Tax Act (FUTA) in 1983, and many states have not raised their taxable wage bases in more than 35 years. Twenty-nine states still have taxable wage bases at or below $15,000. These low wage bases, which have not kept up with wage increases over past decades, threaten funding for UI benefits. Indeed, Vroman (2011) found that among the 16 states that had indexed their wage bases to rise with inflation, only 6 had to borrow from the federal government during the Great Recession; for the 35 states that did not index, 29 needed to borrow.

Having a higher wage base allows greater accumulation of reserves—a rainy day account—so that when unemployment rises, states do not immediately have to raise taxes to pay benefits. Raising taxes is to be avoided if at all possible, because doing so causes employers to reduce hiring and increase layoffs—the exact opposite of what is needed. A good rule of thumb is that reserve balances should be sufficient to pay at least

Despite federal incentives for adequate funding of benefits, our simulations show that UI finances remain insufficient in many states.

one year of benefits at levels comparable to a state's highest annual spending over the past 20 years, called the average high-cost rate, or AHCR. To incentivize this minimum, states that meet it qualify for interest-free short-term loans from the U.S. Treasury should borrowing be needed to pay benefits. Nonetheless, at the end of 2018, 24 states still fell below the threshold. Figure 1 summarizes states' 2018 year-end AHCR values, with lower values indicating smaller balances relative to average high-cost spending.

Figure 1 At the End of 2018, Many States Lacked UI Reserves Sufficient to Cover a Year of Benefits after a Recession



NOTE: Created with mapchart.net.©
SOURCE: USDOL (2019).

Simulating UI Reserve Adequacy after Recessions

When the next recession hits, will states' UI reserves—collectively $66 billion at the end of 2018—be sufficient to pay benefits without having to borrow? We define a state's "reserve ratio" as its end-year UI trust fund balance, net of outstanding U.S. Treasury or bond debt, as a percentage of UI-taxable wages that year. Using annual data from the U.S. Department of Labor, we examine how this ratio changed over each of the five recessions since 1974. The 1991–92 and 2001–02 recessions were mild in terms of UI benefits paid, while the recessions of 1974–75, 1980–82, and 2008–09 were severe. Based on how reserve ratios changed across these types of recessions, as well as an average of the mild and severe, we simulate how reserves could change from their year-end 2018 values during the next recession. As shown in Figure 2, our simulations suggest the following:

1) A severe recession would leave state reserves collectively in the red by nearly $3.8 billion, and 21 states would incur debt to the U.S. Treasury of $30.9 billion.

2) An average recession would leave 18 states short of reserves by an estimated $15.3 billion.

3) A mild recession would reduce collective reserves by over $40 billion, with $25.6 billion left, but 11 states would still need to borrow a total of $8.8 billion to pay UI benefits.

Having a higher wage base allows greater accumulation of reserves—a rainy day account—so that when unemployment rises, states do not immediately have to raise taxes to pay benefits.

Why Are So Many State Reserves Still So Low and at Risk of Insufficiency?

During and after the Great Recession, the 53 state UI programs (including Washington, D.C.'s, Puerto Rico's, and the Virgin Islands') varied in how they tried to rebuild their reserves. Some undertook extensive reforms, many let their programs automatically recover under existing laws, and nearly half paid federal penalties to replenish their UI funds.

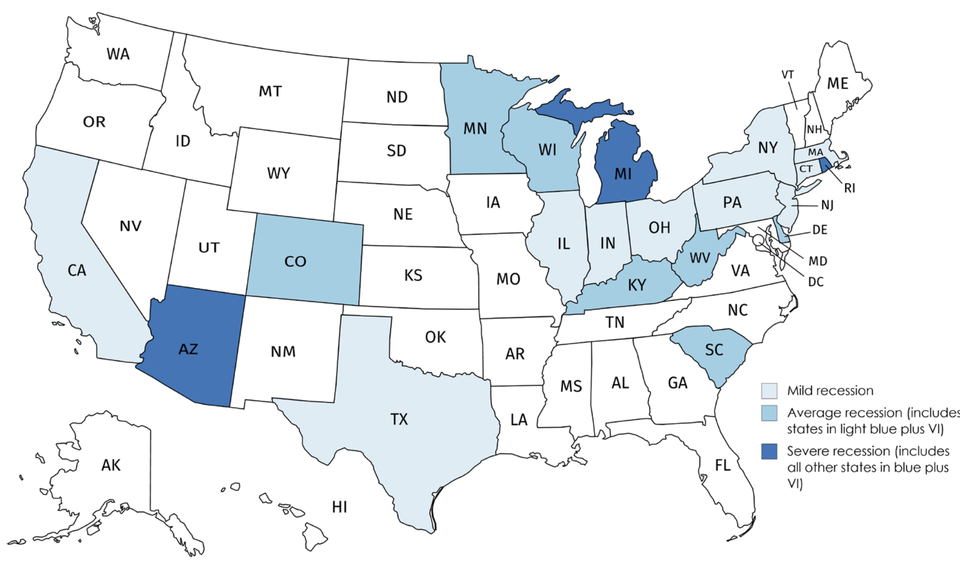
Sixteen states actively improved their UI financing systems by increasing their taxable wage bases or lowering reserve thresholds that automatically trigger tax rate increases, with 4 of these states also cutting benefit generosity. These 16 states are spread across the country and have diverse industrial mixes, and their actions suggest an appreciation for the UI system in contributing to the viability and strength of their state workforces.

Other states have been less proactive. Seventeen states maintained the status quo and simply let their UI financing systems gradually recover. States in this group tend to have above-average reserve ratios, and their UI systems tend to be resilient financially. They typically pay higher-than-average UI benefits, but they also are more likely to have higher tax bases that automatically adjust for payroll growth and tax rates that adjust to maintain UI reserves.

Another 25 states let their UI debt to the U.S Treasury accumulate. Consequently, these states have had to pay penalty taxes through higher tax rates on workers' wages until the debt is paid off. This passive response of allowing higher federal UI taxes is a poor long-term financial strategy, however, because of a cliff effect: once the debt is paid off, the tax rate falls abruptly, and so reserves will start at zero and rebuild only slowly, setting up the system for a repeat failure.

A few other states—6 of them—took active steps that undercut their UI finances. These states had laws that automatically increased UI tax rates on employers when reserves fell sufficiently low, but state officials overrode these laws. Presumably they did so to shield businesses from rate increases and accommodate business growth early in

Figure 2 The Next Recession Would Leave Between 11 And 21 States With Negative UI Fund Reserves, Depending On Its Severity



NOTE: Figure represents results from authors' simulations of UI fund balances across states following recessions of indicated severity, assuming state balances started at year-end 2018 levels. Created with mapchart.net.©

Several reforms could strengthen the system, including increasing the taxable wage base, higher interest rates on state reserves, and lower borrowing costs for crisis loans to states.

the economic recovery, but the decision delayed rebuilding reserves, and 4 of the 6 states still have reserves below the recommended multiple of 1.0 (see Figure 1).

Eight states issued bonds to pay either UI benefits or U.S. Treasury debt. Although bond rates were low in this period, issuing bonds can be a risky strategy when interest rates are volatile, and it shifts employer debt to a general obligation of the state (and the taxpayer). Additionally, a few other states cut benefit durations to reduce future benefit needs. However, several of the states issuing bonds or cutting benefit durations still have low reserves, and our simulations suggest their UI financing is still shaky.

Conclusion

The federal-state UI system exists to provide partial temporary income replacement to involuntarily unemployed workers as they seek reemployment. The system also plays an important macroeconomic role, as this income replacement helps automatically boost spending during business downturns and moderate it during expansions. Adequate funding of benefits reinforces this countercyclical role, but emerging differences in UI financing among states may hamper its effectiveness (O'Leary and Wandner 2018). Several reforms could strengthen the system, including increasing (and indexing to inflation) the taxable wage base, paying higher interest rates on state reserves held at the U.S. Treasury, and reducing borrowing costs for crisis loans to states from the federal government—with rates at or below prevailing municipal bond rates. Without these reforms, many states are likely to experience reserve deficiencies in the next recession.

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