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States Should Quickly Reform Unemployment Insurance

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In this installment of Academic Perspectives on SALT, the authors discuss COVID-19 and how state governments should act to reform unemployment insurance eligibility and benefits and the taxes funding these programs.

COVID-19 is causing mass layoffs and related economic hardship, as well as budget crises for state and local governments.[1] This article is part of Project SAFE (State Action in Fiscal Emergencies), an academic effort to help states weather the fiscal crisis by providing policy recommendations backed by research.[2] This article will focus on how state governments should reform unemployment insurance (UI) eligibility and benefits and the taxes funding these programs.

Economic downturns are the wrong time to worry about fiscal rectitude. Yet, in the past, states have contributed to national economic misery during recessions by reducing benefits, cutting public sector jobs, and raising taxes.[3] Prudent fiscal planning in the form of rainy day funds can help to avoid this dilemma, but no state's rainy day fund is anywhere near large enough to weather the current storm.[4] Borrowing is a painful alternative, but when savings are not enough, it must be embraced. That is especially so now, when we face not an ordinary recession but one in which the capacity of state and local governments to respond to the urgent physical needs of their citizens is in high demand. States must quickly seek additional funds from sources that will not exacerbate economic misery for state residents. Federal aid is especially to be sought because — in contrast to state governments — the federal

[1] Gladriel Shobe et al., "Introducing Project SAFE (State Action in Fiscal Emergencies)," *Tax Notes State*, Apr. 27, 2020, p. 471.

[2] *Id.*

[3] David Gamage, "Preventing State Budget Crises: Managing the Fiscal Volatility Problem," 98 *Cal. L. Rev.* 749, 754-68 (2010).

[4] Grant A. Driessen, "State and Local Fiscal Conditions and Economic Shocks," Congressional Research Service (Mar. 20, 2020) (stating that although there was projected to be roughly $62 billion in state rainy day funds at the end of 2019, "use of rainy day funds alone would likely be insufficient to bridge state financing gaps from a moderate or severe recession"); Michael Leachman and Jennifer Sullivan, "Some States Much Better Prepared Than Others for Recession," Center on Budget and Policy Priorities (Mar. 20, 2020); and Jared Walczak, "State Strategies for Closing FY 2020 With a Balanced Budget," Tax Foundation (Apr. 2, 2020).

government does not operate under balanced budget constraints. The next best source of funds is to seek the cheapest possible sources of credit.

UI has long been proven to be one of the government's most effective fiscal tools against recessions.[5] During the current political climate, it also offers states probably the cheapest source of effective credit, and a nearly limitless one to boot. Put another way, as of the time of writing, the amount of federal aid to the states has been plainly inadequate.[6] The states can reform their UI systems so as to generate substantial additional federal support.

Unfortunately, to access this lifeline, states will have to act aggressively to set aside long-standing resistance to truly effective UI programs — that is, state governments must abandon (at least temporarily) the many needless obstacles that have accumulated over time that make it difficult for individuals to claim UI in an expedient and effective fashion. These barriers have made it difficult not only for individuals to file claims, but also costly and cumbersome for states to process them. News stories abound about states struggling with backlogs of cases that may stretch for months at current processing rates. That is intolerable.

To be clear, we think that most — if not all — of these obstacles probably merit permanent demolition, but we would not make this perfect outcome the enemy of a good (and crucially needed) outcome in the form of temporary waivers. Thus, in this article, we will argue that temporary waivers of many UI obstacles would be an important and urgently needed contribution to state budgets and to the national economy. As we will explain, with some simple steps, states can expand benefits, ease barriers to filing claims, and wipe out long backlogs of individuals waiting for their claims to be processed.

It may be useful for readers to first have a brief overview of how the UI system works and is financed.[7] UI provides payments to qualifying separated workers. States control, subject to some minimum federally set floors, the rules for what makes workers qualify to receive benefits; the systems for verifying that workers meet those qualifications; the fraction of wages that qualifying workers receive; and the rules governing how long benefits are provided.[8] The U.S. Department of Labor is authorized to approve or reject state benefit changes if they are inconsistent with federal law, but federal law provides fairly wide latitude to states in these areas.[9]

State UI benefits are financed by a tax similar to federal payroll taxes (that is, a tax imposed on worker wages up to an annual limit, which varies by state from $7,000 to about $52,000),[10] paid by employers.[11] Taxes are "experience rated," which means that employers whose employees successfully claim benefits are taxed at a higher rate.[12] Obviously, this encourages employers to make claiming benefits hard for workers.[13] The federal government also imposes a small tax on the first $7,000 of each worker's wages, and uses this money mostly to pay any emergency benefits authorized by Congress and to establish a reserve fund for states to access in crisis.

Since payments during recessions are usually inadequate to meet demand, federal law strongly encourages states to establish a trust fund account, which serves as a kind of rainy day fund for UI benefits. States that deplete their own reserves can borrow against the federal fund, which in turn can borrow against general federal revenues. Federal law requires states to begin

[5] Walter Nicholson and Karen Needles, "Unemployment Insurance: Strengthening the Relationship Between Theory and Policy," 20 *J. Econ. Perspectives* 47, 48 (2006).

[6] Elizabeth McNichol et al., "States Need Significantly More Fiscal Relief to Slow the Emerging Deep Recession," Center on Budget and Policy Priorities (Apr. 14, 2020).

[7] Readers can find somewhat longer summaries in Congressional Budget Office, "Unemployment Insurance in the Wake of the Recent Recession," CBO Pub. No. 4525 (Nov. 2012), and U.S. Department of Labor, "Unemployment Compensation: Federal-State Partnership" (May 2019); and a much more extensive discussion in Brian Galle, "How to Save Unemployment Insurance," 50 *Ariz. St. L.J.* 1009 (2019).

[8] *See* U.S. Dep't of Labor, State Unemployment Insurance Benefits.

[9] *See* U.S. Dep't of Labor, *supra* note 7, at 3-6, 11; and 26 U.S.C. section 3304(a).

[10] U.S. Department of Labor, Significant Features of State Unemployment Insurance Laws Effective January 2020.

[11] Alaska, New Jersey, and Pennsylvania also collect some tax from employees. U.S. Dep't of Labor, *supra* note 7, at 8.

[12] *Id.* at 10.

[13] Patricia M. Anderson and Bruce D. Meyer, "The Effects of Firm Specific Taxes and Government Mandates With an Application to the U.S. Unemployment Insurance Program," 65 *J. Pub. Econ.* 119 (1997).

repaying some of these loans relatively quickly — by September 30 for loans taken out before May of this year.[14] Loans taken between May and September will not be due until December 2021, although interest will accrue in the interim.[15] Federal law imposes substantial penalties if balances are not eventually repaid.[16] In the aftermath of 2008, however, Congress suspended interest payments for an additional two years.[17] Federal law now authorizes interest-free borrowing for states that hit trust fund targets,[18] and while about 60 percent of states were at that target in February, the interest suspension lasts only until October 1.[19]

This combination of rules creates both serious dangers and major opportunities for states. The dangers are largely dangers of stasis. The combination of experience rating, political economy, and poor program design has resulted in significant pressure on states to minimize benefits and make them difficult to claim.[20] Adding to these intentional obstacles, the challenge of massive spikes in public need and claim filings has resulted in performance that is, predictably, four-letter-word inspiring.[21] Further, if states comply with their existing experience-rating laws, they will soon begin hiking taxes to fill their empty trust funds, further delaying any economic recovery.

But the present opportunities to improve UI systems are great as well. More than 20 states began 2020 with balances in their UI trust funds that were too low to meet a standard measure of adequate savings.[22] The widespread fiscal pain this entails suggests that there will almost certainly be, at minimum, a repeat of the American Recovery and Reinvestment Act approach of suspending interest on state debts for a substantial period, and there will likely be considerable pressure to wipe out at least a portion of state debts to the federal fund. We say this both as a positive prediction of what we expect from the federal government, and as a normative statement of what the federal government should do as part of making the UI program function appropriately in this crisis.

States, in short, can reasonably expect to be able to borrow at minimal interest to fund essentially unlimited UI expenditures. Further, since the state UI trust fund is not a balance sheet item in most jurisdictions, this borrowing will not affect legal balanced-budget obligations.

We should acknowledge that this recommendation comes with fiscal risks. Admittedly, not all bond rating agencies will overlook state UI debts, but at current interest rates, the marginal cost of a slightly lower rating is modest compared with the budgetary and human payoffs. After the Great Recession, states scrambled to repay the federal government before penalty provisions kicked in, including by cutting benefits. Some states found that they could secure lower interest rates through general obligation bonds than by borrowing from the U.S. Treasury.[23] Our argument is that the nation has likely learned enough from this experience not to repeat it. Even if not, the choice between UI borrowing now, when unemployment rates are in double digits, and slightly higher taxes in several years seems to us an easy choice.

For these reasons, state governments should massively increase UI spending, beginning as soon as possible, and then devote every effort to qualifying as many beneficiaries as possible rapidly. Under the recently enacted Coronavirus Aid, Relief, and Economic Security (CARES) Act, Congress provides an additional $600 per qualifying worker per benefits period payment, all fully federally funded.[24] This offers massive potential economic relief and potential stimulus to local economies, with obvious knock-on effects

[14] U.S. Dep't of Labor, *supra* note 7, at 8.

[15] *Id.*; *see generally* 20 CFR section 606.

[16] U.S. Dep't of Labor, *supra* note 7, at 8-9.

[17] American Recovery and Reinvestment Act of 2009, P.L. 111-5, 123 Stat. 115 (2009).

[18] U.S. Dep't of Labor, *supra* note 7, at 9-10.

[19] U.S. Dep't of Labor, State Unemployment Insurance Trust Fund Solvency Report 2020; 20 CFR 606.32.

[20] *See* Galle, *supra* note 7, at 1030-36.

[21] *See* Gary Fineout and Marc Caputo, "'It's a Sh-- Sandwich': Republicans Rage as Florida Becomes a Nightmare for Trump," *Politico*, Apr. 3, 2020 (quoting Florida official describing Florida's UI administration as a "sh*t sandwich."); *see also* Lawrence Mower, "Ron DeSantis Was Warned About Florida's Broken Unemployment Website Last Year, Audit Shows," *Tampa Bay Times*, Mar. 31, 2020.

[22] U.S. Department of Labor, *supra* note 19.

[23] U.S. Department of Labor, *supra* note 19.

[24] CARES Act section 2104.

for revenue sources such as state and local sales taxes. Yet under current law in some states, relatively few separated workers will receive any benefits. For instance, in Southern and Mountain states, fewer than one in five workers who lose their jobs typically receive UI.[25]

States should thus act immediately to remove as many obstacles to claiming benefits as possible. Ideally, states would ask employers to identify every separated worker, and automatically enroll those workers for UI benefits. If verification procedures were deemed necessary, state agency employees could follow up later, and separated workers who are ultimately deemed ineligible could be cut off from additional benefits. Now, though, the burdens of inertia and bureaucratic box-checking should rest entirely on the state. To facilitate this process, states should suspend experience rating,[26] and perhaps even offer small bounties to employers that identify workers who successfully claim benefits.

States should also be creative in expanding eligibility for benefits. Federal law, for instance, already allows states to grant benefits for "short time" or "work sharing" employees, whose positions are not eliminated but whose hours are reduced.[27] Nevertheless, about 20 states do not use this authority presently. The CARES Act encourages short-time programs by paying 100 percent of the state's 2020 benefit payments. Even states whose laws don't authorize short-term benefits can get a 50 percent federal contribution by entering into a temporary agreement with the U.S. Department of Labor.[28]

Again, because federal law places no real caps on state benefit generosity, states have the flexibility to vastly expand benefits for part-time workers, to lengthen benefits duration, to make "replacement rates" (that is, the fraction of former wages paid by UI) much higher, and to offer transitional training and job search assistance. Although the CARES Act provides a modest benefit for gig and other nontraditional workers,[29] states could still take greater steps to provide a lifeline to these workers.

A traditional worry about many of these approaches, especially about long-term and hassle-free benefits, is that they might discourage workers from seeking new work. Recent social science shows these fears are overblown. Especially in recessions, when work is scarce, workers are reluctant to turn down any work opportunities.[30] There is, in other words, little moral hazard during recessions. States could return to their old policies when the crisis is far in our rearview mirrors, but for now, there is little downside to dramatically increasing the ease and generosity of UI programs.

When the coronavirus crisis is over, the country will need to confront the poor program design choices that made UI a shadow of what it was made for.[31] We hope to address some of these steps in a later article. But even now, before such reform, the system has enough flexibility that states can abandon decades of bad policy and transform UI into the crisis stopper it was designed to be. States should take advantage of this flexibility promptly to prevent unnecessary harm. ■

[25] U.S. Department of Labor, Chartbook, Recipiency Rates by State 2019.

[26] At least 16 states have already done this. National Employment Law Project, "Policy Brief: Unemployment Insurance Protections in Response to COVID-19: State Developments" (Mar. 27, 2020).

[27] 26 U.S.C. section 3306(v).

[28] CARES Act sections 2108, 2109.

[29] CARES Act section 2102.

[30] Kory Kroft and Matthew J. Notowidigdo, "Should Unemployment Insurance Vary With the Unemployment Rate? Theory and Evidence," 83 *Rev. Econ. Stud.* 1092, 1093 (2016); Jesse Rothstein, "Unemployment Insurance and Job Search in the Great Recession," Brookings Papers on Economic Activity, at 143, 181 (Fall 2011); Johannes F. Schmieder et al., "The Effects of Extended Unemployment Insurance Over the Business Cycle: Evidence From Regression Discontinuity Estimates Over 20 Years," 127 *Q.J. Econ.* 701, 703, 746 (2012).

[31] *See* Galle, *supra* note 7, at 1049-63 for proposals.