

Action area 6

Rebuilding and stabilizing the funding of state UI benefits



Building Resilience:

A plan for transforming unemployment insurance

Action area 6

Rebuilding and stabilizing the funding of state UI benefits

States pay unemployment insurance (UI) benefits using funds from individual state unemployment accounts, known as “UI trust funds.” The ability of states to maintain sufficient UI trust fund reserves and meet their benefit obligations during recessions has declined in recent years. The changing nature of work, including employers' increased reliance on permanent separations rather than temporary layoffs, is an important contributing factor; however, a major challenge has been states' ability to generate sufficient payroll tax revenues.

Prior advisory bodies have recommended that states use “forward funding” to generate sufficient reserves.¹¹⁰ Forward funding refers to the practice of states building up their UI trust fund reserves when the economy is strong in anticipation of larger benefit outlays during economic downturns. States' gradual movement away from this practice has resulted in several negative changes for unemployed workers, and risks weakening the UI system's ability to meet its counter-cyclical objectives related to macroeconomic stabilization.

The UI system is financed through state and federal payroll taxes on employers.¹¹¹ Under the provisions of the Federal Unemployment Tax Act (FUTA), an effective federal tax rate of as low as 0.6 percent is levied on the first \$7,000 of a covered employee's earnings (i.e., the taxable wage base), which amounts to \$42 per covered employee per year.¹¹² Federal contributions are primarily used to fund the administration of state UI programs, advances to states, and the federal share of Extended Benefits during recessions.

¹¹⁰ Advisory Council on Unemployment Compensation, *Collected Findings and Recommendations, 1994-1996* (1996), <https://research.upjohn.org/externalpapers/1/>.

¹¹¹ In three states, Alaska, New Jersey, and Pennsylvania, employees also pay small payroll taxes; the federal tax is not levied on workers.

¹¹² Under FUTA, the federal unemployment tax is levied on covered employers at a rate of 6.0 percent. FUTA also provides credits against federal unemployment tax liability of up to 5.4 percent to employers who pay state taxes timely under a conforming state UI program. Accordingly, in states meeting the specified requirements, employers pay an effective federal unemployment tax of 0.6 percent. For more information, see Department of Labor, Employment and Training Administration, *Comparison of State Unemployment Insurance Laws 2023*, <https://oui.doleta.gov/unemploy/comparison/2020-2029/comparison2023.asp>.

State UI benefits are financed by state payroll taxes. Across all states, the amount of contributions an employer pays depends on the number of employees, the state's taxable wage base, and the tax rate assigned to the employer. State tax rates fall within statutorily set minimum and maximum thresholds.

An important dimension of UI financing in the U.S. is experience rating. This refers to the practice of adjusting employers' tax rates according to how much former employees claim benefits. It is designed to discourage unemployment by making employers pay for the costs of their layoff decisions, and equitably allocate the costs of unemployment. However, research suggests it may incentivize employers to contest the UI claims of their former employees and keep UI taxes low.¹¹³

With the \$7,000 federal base as the legal floor, most state taxable wages bases do not exceed \$15,000.¹¹⁴ Unlike another important social insurance program, Social Security, the federal UI base is not indexed to inflation and has increased just three times since 1935, most recently in 1983. Recent research found that while more than three quarters of all covered earnings are taxable under Social Security, only just over one quarter of all UI covered earnings are subject to taxation.¹¹⁵ While states can set a tax base above the federal minimum, they are not required to do so, and the low federal benchmark limits the amount of payroll tax revenue states generate to support payment of UI. The low tax base also means employers of low-wage workers pay a higher share of their employees' wages in UI taxes.

Forward funding as a method of financing UI began declining in the early 1990s. A steady decline in UI tax rates since then resulted in a measurable deterioration in the level of state UI trust fund balances.

¹¹³ Alix Gould-Werth, "Workplace experiences and unemployment insurance claims: How personal relationships and the structure of work shape access to public benefits," *Social Service Review*, vol. 90, no. 2 (June 2016), pp. 305-352, www.jstor.org/stable/26463049; Alexander Hertel-Fernandez, "Dismantling Policy through Fiscal Constriction: Examining the Erosion in State Unemployment Insurance Finances," *Social Service Review*, vol. 87, no. 3 (September 2013), <https://doi.org/10.1086/672460>.

¹¹⁴ Department of Labor, Employment and Training Administration, *Significant Provisions of State UI Laws, Effective July 2023* (July 2023), <https://oui.doleta.gov/unemploy/content/sigpros/2020-2029/July2023.pdf>.

¹¹⁵ Chris O'Leary and Kenneth Kline, *State Unemployment Insurance Reserves Are Not Adequate* (W.E. Upjohn Institute for Employment Research, March 2020), https://research.upjohn.org/cgi/viewcontent.cgi?article=1340&context=up_workingpapers.

At the end of 2007, following more than six years of economic expansion, state UI trust fund balances, on average, could pay out approximately five months of average recessionary benefit outlays, a historically low level for that period in an economic cycle. As a result, a total of 36 states were forced to borrow funds from the federal government under Title XII of the Social Security Act (SSA) in order to pay UI benefits during the Great Recession, with outstanding advances averaging 76 months. This does not account for additional states that turned to the private bond market to finance their trust fund deficits.

Later, because of the historic increase in unemployment and UI benefits during the pandemic, 23 states were forced to borrow funds in order to continue paying benefits. While four of these states maintained advance balances as of January 1, 2024, state borrowing was significantly reduced by the availability of alternative funding sources provided by Congress under the Coronavirus Aid, Relief, and Economic Security Act and the American Rescue Plan Act (ARPA). As of September 30, 2023, just 14 states' UI trust funds met the Department's minimum recommended level of solvency.

When UI programs are not forward funded, states might decide to lower benefits, increase taxes or a combination of both, when the economy is weak. During the Great Recession, the need for borrowing states to repay federal advances and states' desire to avoid tax increases over this period triggered significant benefit reductions, such that in 2019, the last full pre-pandemic year, fewer than three in 10 unemployed workers received UI benefits; in 13 states, this share was below 15 percent.

A state's trust fund balance also impacts the range of tax rates assigned to employers based on their experience for a given tax year. In general, the range of rates goes up when states' trust fund balances decrease, and they decline when balances increase. This is another reason why forward funding is important, as employers are best positioned to absorb tax increases when the economy is strongest. In order for a countercyclical stabilizer such as UI to best function, it should build up funding capacity when the economic environment is favorable.

Obtaining advances can also create difficult political decisions for a state. For example, if an advance results in interest coming due, a state must finance the interest payment from a source other than the regular UI tax. Therefore, maintaining solvent state UI trust funds is in the best interest of all involved. Recognizing these issues, the Department of Labor (the Department) issued regulations in 2010 that set funding goals for state unemployment trust funds and restricted certain benefits (e.g., the ability to receive interest-free cash flow borrowing) to those states that met forward-funding goals.¹¹⁶

The Department plans to continue generating resources that provide information and educate the public on the status of states' UI solvency. Ultimately, legislative action is needed to fully stabilize the funding of state UI programs.

Strategies

Underway	
<p>6.1. Continue publishing an annual report as a means to provide information and educate the public on the status of states' UI solvency</p>	<p>The Department is using opportunities to educate and provide technical assistance to policymakers regarding the need for solvent, stably funded state UI programs, and the risk posed to states' UI benefit adequacy when states fail to properly fund their programs.</p>

¹¹⁶ Tax credits under the Federal Unemployment Tax Act; Advances under Title XII of the Social Security Act, 20 C.F.R. Part 606 (April 2007), www.ecfr.gov/current/title-20/chapter-V/part-606.

Proposed legislative reform

- **Improve state and federal trust fund solvency** – The pandemic severely drained state unemployment trust funds, and comprehensive UI reform must improve state and federal solvency through equitable and progressive financing mechanisms.
- **Reduce the incentives for employers to contest legitimate UI claims** – As noted earlier, UI taxes are experience rated. This means that the rate an employer pays in state UI taxes changes based on their individual “experience” with unemployment. The purpose of this practice, which dates back to the enactment of the SSA in 1935, is to discourage layoffs by making employers pay for the costs of their contributions to overall unemployment. Put simply, high-layoff employers are charged higher taxes. In all states except Alaska, however, this rate is based on the amount of benefits claimed by former employees and not the number of people laid-off.¹¹⁷ The bipartisan Advisory Council on Unemployment Compensation noted that some members warned “that experience rating causes employers to make excessive use of the system’s appeal mechanism in an attempt to keep their experience-rated taxes as low as possible.”¹¹⁸ Research on laid-off workers’ UI claims-filing experiences during the Great Recession also describes instances where some employers actively deterred UI receipt.¹¹⁹ A reformed UI program should examine ways it may reduce incentives for employers to wrongly contest UI claims.

¹¹⁷ For more information on the different types of experience rating used by states see Department of Labor, Employment and Training Administration, *Comparison of State Unemployment Insurance Laws 2023*, Financing, Chapter 2 <https://oui.doleta.gov/unemploy/pdf/uilawcompar/2023/financing.pdf>.

¹¹⁸ Advisory Council on Unemployment Compensation, *Collected Findings and Recommendations, 1994-1996*, (1996), <https://research.upjohn.org/externalpapers/1/>.

¹¹⁹ Alix Gould-Werth, “Workplace experiences and unemployment insurance claims: How personal relationships and the structure of work shape access to public benefits,” *Social Service Review*, vol. 90, no. 2 (June 2016), pp. 305-352, www.jstor.org/stable/26463049.