



Why U.S. Unemployment Insurance is in Financial Trouble

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Unemployment insurance is an important part of America's safety net. When jobs are lost, the program's benefits sustain people while they look for new positions. Families and communities benefit, too – and the national economy gets a boost.

But vital as unemployment insurance may be, the U.S. system is going broke. Each U.S. state operates a "trust fund" to cover benefits. By the third quarter of 2011, 27 state funds were insolvent, forcing their governments to borrow money from the national treasury to cover regular claims by unemployed workers. The economic downturn was partly responsible, of course. Yet the fact is that the U.S. unemployment system was already in feeble financial shape *prior* to the start of the Great Recession in 2008. It is important to understand why this happened, so policymakers and citizens' groups can consider good ways to revitalize the system.

How U.S. Unemployment Insurance Works

The unemployment insurance system was created in 1935. The New Dealers who designed the system intended unemployment benefits to kick in as temporary replacement for a portion of the wages lost when Americans with established work histories lost jobs through no fault of their own. In addition to easing financial hardship and boosting the economy, policymakers wanted the financing of the system to stabilize employment. Business taxes are used to finance regular benefits – and the idea was to reduce taxes on firms that rarely laid off workers, yet keep taxes high, or raise them, on firms that had higher layoff rates.

To make it all work, states from Alabama to Vermont play a central role. Every state sets up their own unemployment insurance program and within broad guidelines each state's government has discretion – to decide which workers are eligible for benefits, to establish the level and timing of benefits, and to determine the taxes businesses pay to build up the trust fund.

Why Have the System's Finances Eroded?

Not because benefits are overly generous. Across all states, benefit payments average about \$300 per week and replace slightly less than half of a typical worker's wage. Because workers must show a history of sustained employment prior to claiming benefits, many categories of workers are not eligible for help. In recent years, only a minority of the unemployed – slightly more than a third – have been eligible to claim regular state unemployment insurance benefits.

Instead, *the system's finances are in trouble because of steadily reduced taxes.* States collect payroll taxes from employers in order to be ready to pay benefits to covered workers. That is how the system is supposed to work. But since the 1980s, many states have competed with one another to see who can reduce taxes on business the most. States, taken together, have steadily reduced the revenues necessary to reliably maintain the solvency of unemployment insurance programs. Two trends tell the details:

- **Many states are taxing a declining proportion of workers' wages.** States do not require employers to pay unemployment insurance taxes on a worker's entire wage; rather, employers pay taxes on wages on up to a certain maximum, called the "taxable wage base." The best way to keep that base from eroding in relation to total wages is to automatically adjust it each year to reflect any growth that may occur in average wages. A handful of states do this, including Alaska, Washington, Hawaii, and Oregon. But most states do not follow this practice. They only update the wage base sporadically. As of 2011, 21 states had set taxable wage bases of \$10,000 or less per worker each year. This level amounted to a lower portion of wages than in previous decades.
- **Tax rates have not increased to make up the difference.** If the fraction of wages taxed declines, one way to sustain revenues would be to increase the tax rate. But this has not happened in most states.

The tax rate that particular employers pay varies depending on each employer's history of layoffs (among other factors). But the key fact is that, on average, employers are paying less into the system than they once did. Indeed, average tax rates had fallen below what the federal government considers the level necessary to maintain solvency in all but six states in 2009.

Why It Matters – and What Should be Done

At its best, America's unemployment insurance system works to counter economic downturns – sustaining families and putting more consumer purchasing power into the economy when many businesses are struggling. But the breakdown of finances for state unemployment insurance programs threatens this crucial corrective function.

Here's why: When states exhaust their reserves, they respond by taking out loans from the federal government to cover the benefits they have to keep paying – loans that are supposed by law to be repaid, with interest, to the U.S. Treasury in two to three years. If the states fail to repay on time, their employers face automatic federal tax increases. To avoid this, states may increase their own tax collections from employers – or cut benefits for the unemployed. In the wake of the Great Recession of 2008-09, at least ten states have already cut benefits for the unemployed.

In sum, states that excessively reduce taxes for unemployment insurance in normal economic times set the stage for deep trouble when the economy goes sour. States may think they are doing employers a favor by shrinking taxes. But when the next recession comes along – and the unemployment trust fund is wobbly or insolvent – the government will be forced to make things worse for businesses and workers alike.

Clearly, America's federal and state governments need to devise a better way to sustain unemployment insurance. All states should automatically update regular tax payments to keep pace with annual wage increases. And when a national crisis strikes, the federal government should provide immediate grants (not loans) to cover unemployment benefits. This would lift the burden on state governments, employers, and workers alike – at a time when everyone needs the economic boost the most.