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FINANCING UNEMPLOYMENT INSURANCE:

Fiscally Responsible Steps to Trust Fund Solvency for Policymakers

Timely, accessible, and credible analysis of state and local budget and tax issues

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KEY FINDINGS:

- **Unemployment benefit payments have generated an estimated $23.3 billion in economic activity in North Carolina communities.[1] At a time when consumer spending remains low, these payments not only sustain local businesses but provide a modest support for working families who have experienced job loss through no fault of their own.**
- **North Carolina's unemployment insurance trust fund was below safe levels before the Great Recession hit and put tens of thousands of North Carolinians out of work. A series of tax changes in the 1990s reduced how much employers were required to contribute to the trust fund and took $1.5 billion out of the unemployment insurance system.[2]**
- **North Carolina can make two key policy changes to make an unemployment insurance system that is sustainable, equitable and sets the Trust Fund on the path to solvency. These include expanding the taxable wage base and reforming the experience-based rating system.**

Overview

The federal government set up the unemployment insurance system to support the economy during downturns, recognizing that the economy suffers when workers lose their jobs. It is a "forward financing" system—employers contribute more to the unemployment insurance trust fund in good times, when their payrolls are high, so that in tough times the fund can provide benefits to laid-off workers, even as employers' payrolls shrink. This countercyclical function of the unemployment insurance system is essential to sustaining the promise of recovery. During down times, benefit payouts support consumer spending and needed economic activity, helping to fuel eventual expansion and hiring and thereby sustain business.

Since the official end of the Great Recession, unemployment insurance payments have represented more than 1 percent of total personal income in North Carolina. From June 2009 to July 2011, $14.2 billion in unemployment insurance payments from state and federal sources were made in North Carolina. Research by the Moody's Corporation found that for every $1 in unemployment benefits, $1.64 is generated in economic activity. Thus, unemployment benefit payments have generated an estimated $23.3 billion in economic activity in North Carolina communities.[3] At a time when consumer spending remains low, these payments not only sustain local businesses but provide a modest support for working families who have experienced job loss through no fault of their own.

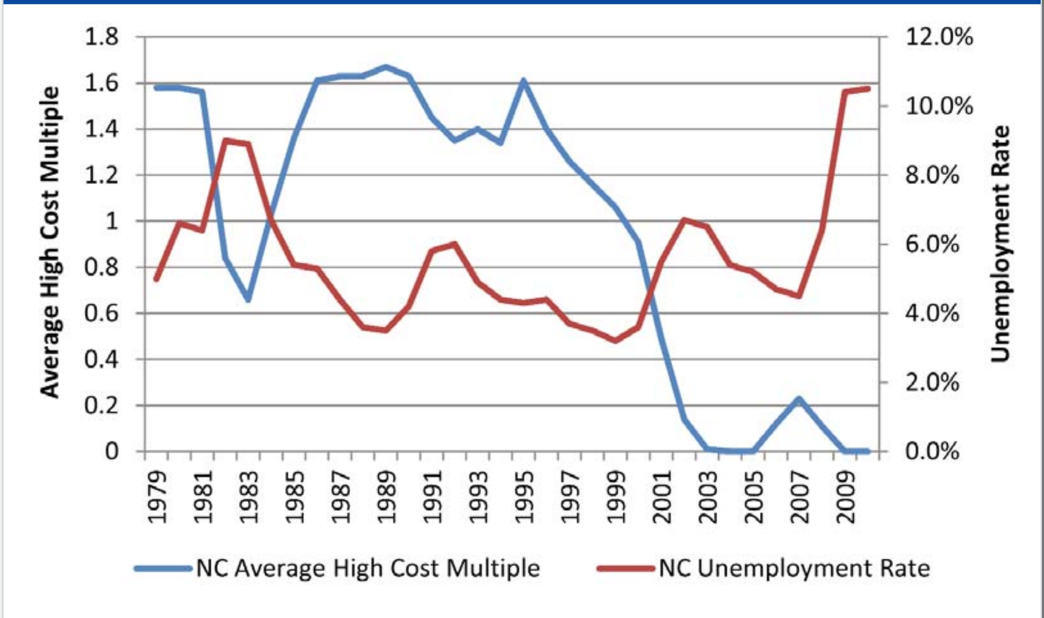
Given the critical role that unemployment insurance payments play in the state's economy and recovery, North Carolina needs a financing system that can adequately support these payments and remain stable through the ups and downs of the business cycle—even through a downturn as severe as the Great Recession.

The State of North Carolina's Unemployment Insurance Trust Fund

North Carolina's unemployment insurance trust fund was below safe levels before the Great Recession hit and put tens of thousands of North Carolinians out of work. A series of tax changes in the 1990s reduced how much employers were required to contribute to the trust fund and took $1.5 billion out of the unemployment insurance system.[4]

Researchers have formulated two methods for determining the adequacy of an unemployment insurance trust fund. One uses a percentage of total wages paid in the last 12-month period (reserve ratio); the other takes the average of the three most recent high-cost calendar years that include either three recessions or at least 20 years' history (the average high-cost multiple). North Carolina has failed to reach these metrics since the 1990s and therefore was unprepared for the growth in claimants that began with the Great Recession.

FIGURE 1: UI Trust Fund Became Insolvent Before Unemployment Increased



Looking just at the average high cost multiple measure, North Carolina's trust fund adequacy was falling well before the unemployment rate hit historic levels in the Great Recession. The average high cost multiple–which should remain above one for trust fund adequacy–first fell below that level in 2000 before the first recession of the decade pushed up unemployment.

Creating a Solvent Trust Fund

Employers have already begun paying increased unemployment taxes as a result of the state's trust fund becoming insolvent. That is because policy-makers put in place an important policy, the minimum safe level tax, that kicks in when the trust fund balance falls below a safe level and this has allowed North Carolina to make interest payments on the loan balance. But further automatic increases will occur in the future if North Carolina policymakers do not immediately pay down the trust fund balance through federal law that imposes an across-the-board increase on employers' credit into the federal UI system.[5] This is not an efficient way to finance the UI system.

North Carolina can make two key policy changes to make an unemployment insurance system that is sustainable, equitable and sets the Trust Fund on the path to solvency.

Expand the taxable wage base through better indexing. North Carolina is one of 17 states that wisely index their taxable wage bases for growth in payrolls. In other words, the amount of wages subject to taxation automatically increases along with wages and salaries. North Carolina's 2010 wage base is $19,700, so an employee's wages above that amount are not subject to the unemployment insurance tax. An indexed taxable wage base allows the financing of the unemployment insurance system to keep pace with the loss

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of wages and has been linked to improved trust fund solvency—except in the case of North Carolina. North Carolina's taxable wage base is indexed to 50 percent of the state's average annual wage. Increasing the taxable wage base from this current level incrementally to 80 percent of the average annual insured wages paid in the state could significantly improve the solvency of North Carolina's trust fund. It would do so by keeping pace with wage levels and capturing more of the wage payments made in the state. An additional critical component to this effort will be insuring that employees are not misclassified and therefore not included in the calculation of taxable wages. The US Dept. of Labor estimates for every 200,000 employees misclassified – usually as independent contractors – the loss to Federal unemployment taxes collected is $11M and much more to states.[6]

Reform the experience-rating system to better align taxes paid with benefits from the unemployment insurance system. An employer's unemployment-insurance tax rate is based on their experience rating—employers with more workers claiming unemployment benefits pay higher tax rates. However, there are important ways in which North Carolina's experience rating system can better strengthen the link between taxes paid and benefits claimed.

- The standard beginning rate for a new employer without a record of employment is set at 1.2 percent in North Carolina. Only two states have a new employer rate at this level. Raising the beginning rate to some level near the highest credit rate of 2.7 percent is in line with the practice of 13 other states and should be considered.
- The minimum tax rate sets the floor for any employer, ensuring that all eligible employers share in the costs of this social insurance system. But that only works if the minimum rate is above zero. North Carolina has set its minimum tax rate at zero percent.
- The tax-rate range and increments between them can ensure that employers truly pay the costs of their experience with the system; for example, a smaller increment between rates creates a closer connection between the employer's experience and their payment to the system.[7] Aligning the maximum contribution rate with national practice, where thirty four states have maximum rates higher than North Carolina, is an important part of the effort to connecting experience with and payment into the system.[8]

Ultimately, analysis of these scenarios will be required to determine when these changes can move the Trust Fund to solvency and the impact on employers. However, best practice and national evidence suggests that these policies provide the greatest potential for restoring the long-term health of the Trust Fund.

Conclusion

Unemployment Insurance is a counter-cyclical tool effective at boosting the economy. But in order for it to work, workers who have lost their jobs through no fault of their own must be able to access payments and spend them in their community, and employers must contribute enough to the system in good times. North Carolina policymakers now are faced with the immediate challenge of a system that is not solvent. Moving forward, policymakers can design a system that ensures the counter-cyclical role of the unemployment insurance system is strengthened and businesses benefit from more stable consumer spending.

1 Sirota, Alexandra, September 2011. Still Unemployed After All These Years: State of Working North Carolina Series: NC Justice Center, Raleigh, NC.

2 Research by Mark Zandi at Moody's.com. Analysis released by the Bureau of Labor Statistics found that unemployment benefits paid out since December 2007 provide $2 in economic activity for every $1 paid out. Thus, the estimates in this report are conservative.

3 Author's calculation based on Moody's multiplier.

4 Sirota, Alexandra, March 2011. The Path to Insolvency: Tax Changes, Great Recession Drive Unemployment Insurance Trust Fund Challenges. BTC Brief: NC Justice Center, Raleigh, NC.

5 For more on the federal and state interactions in the UI system see: Quinterno, John, 2007. "Buddy Can You Spare a Dime? Putting NC's Unemployment Insurance System Back to Work." NC Budget and Tax Center: Raleigh, NC.

6 Crowley, Tom. 2009 National Unemployment Tax Conference

7 GAO, July 2006

8 General Accountability Office, 2010.

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