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GETTING SOLVENT:

Rebuilding the Unemployment Insurance Trust Fund to Protect North Carolina's Economy

BY ALEXANDRA FORTER SIROTA, *Project Director*

Introduction

The federal government established the unemployment insurance system after the Great Depression to support workers who lost their jobs through no fault of their own and to ensure that the economy could recover in the face of massive job loss. By providing temporary wage replacement, unemployment insurance enables jobless workers to maintain a modest level of economic security as they seek new employment.

As originally conceived, the unemployment insurance system would be funded through forward-financing—employers contribute to an unemployment insurance trust fund in good times so that in bad times, when benefit payouts increase and payrolls shrink, funds are available for jobless workers. Together, wage replacement and forward-financing can create an unemployment insurance system that protects the overall economy—workers and businesses alike—especially in historic downturns.

The Great Recession, which began in December 2007 and officially ended in June 2009, demonstrated the importance of unemployment insurance to workers and the economy. It has also made clear the problems that arise when the system abandons the fundamental design of forward-financing.

North Carolina's Trust Fund is insolvent, having failed to build an adequate balance before the onset of the Great Recession, which quickly led to a drawdown of available funds as unemployment soared. The current crisis in the solvency of North Carolina's unemployment insurance (UI) trust fund stems from state legislators' decision to cut employer contributions to the fund in the 1990s, and it was made worse by the unprecedented levels of job loss and long-term unemployment that have characterized the Great Recession and its aftermath. In such cases, the federal government offers loans to help states meet their responsibilities under the UI system. North Carolina began borrowing from the federal government in 2009; as of May 2012, the state had borrowed $2.4 billion.[1]

North Carolina's UI trust fund insolvency did not happen overnight and will require time to address. As policymakers seek to improve the solvency of the system so that it works well for workers, employers and the economy as a whole, they should endeavor to do the following:

- **Build a system that can better weather economic downturns** by ensuring adequate fund levels to reduce the reliance on borrowing to meet benefit payments in downturns.
- **Maintain the system's ability to support the economy** with wage-replacement levels that are adequate to support workers seeking work.

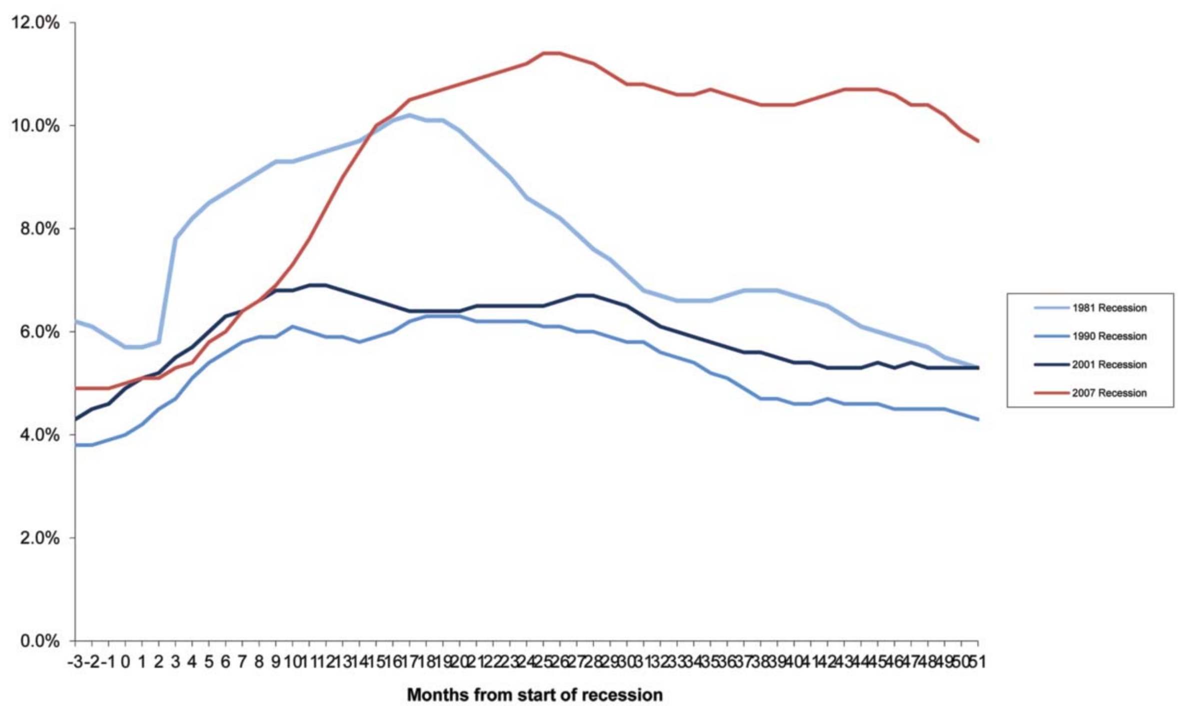
The Budget and Tax Center conducted a thorough analysis of the unemployment insurance system in March 2007, before the start of the Great Recession, warning of the long-term unsustainability of the system as implemented and suggesting reforms. This report picks up where the 2007 report left off and analyzes the current financial challenges to the system and presents options for reform.

The Current Labor Market and Economy in North Carolina

North Carolina, like 26 other states, continues to borrow from the federal government to sustain its unemployment insurance (UI) system now almost three years past the official end of the Great Recession. The state has seen only slight improvement in its employment outlook over the recovery period, and it is therefore not surprising that the unemployment insurance system continues to experience pressure.

While initial UI claims had almost returned to pre-recession levels as of March 2012, unemployment overall remained high at 9.7 percent. The state's job deficit stands at 528,000—this is the number of jobs the state needs to add to make up for the loss of jobs during the recession and keep up with the growth in the working-age population.[2]

FIGURE 1: Unemployment Rates has remained higher longer than any of the previous four recessions



The severity of the Great Recession, as measured by both duration and decline in economic activity, was the worst of any recession in the post-World War II period. The previous 10 recessions from 1946 to 2006 averaged just 10.5 months, while the Great Recession lasted 18 months. Overall for the nation, the lowest points of employment and output during the recession represented a decline of 6.3 percent and 5.1 percent respectively from the previous peak.[3]

There is growing concern that the nature of recessions in the more recent period has changed, and that is particularly true in North Carolina. Downturns had been considered to be primarily cyclical and temporary. The recessions of the 2000s, while clearly driven by the overall economic decline, have been compounded particularly in North Carolina by the structural decline of traditional industries.[4] Fewer jobs overall, the decline in manufacturing jobs accelerated by the Great Recession, and the growth in low-paying service-sector jobs in the recovery increase the challenges for North Carolina's workforce.

In addition to these trends, numerous researchers have documented other changes in the labor market—such as the rise in temporary and low-wage work, the decreased reliance on a single paycheck with two wage-earners in a family, the increase in self-employment (which is not covered by unemployment insurance), and the increase in long-term unemployment[5] — that present renewed need for a strong unemployment insurance system. In the context of these labor market conditions and financial realities, efforts to strengthen the unemployment insurance system have become increasingly urgent.

That is particularly true because of the benefit unemployment insurance provides to the economy overall. From December 2007 through 2009, more than $4 billion were provided in unemployment insurance payments, maintaining consumer spending at reduced but stable levels.[6] Research by the U.S. Department of Labor on the stabilizing effect of unemployment insurance in the Great Recession found that for every $1 in unemployment insurance paid out, $2 in economic activity is generated.[7]

Fundamental to such an effort is ensuring the financial health of the system so that it can respond to a changing labor market and modern economy.

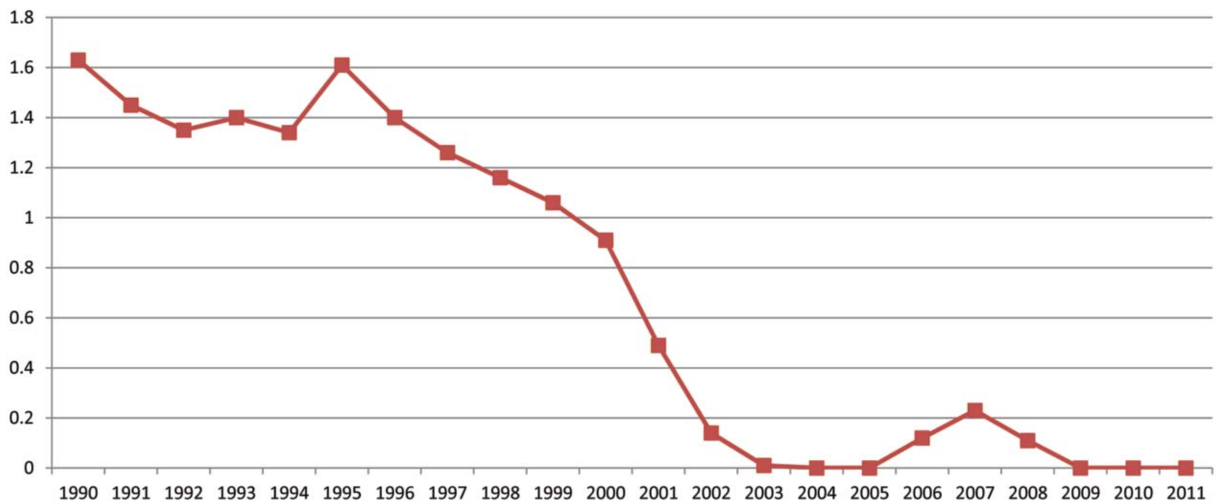
How We Got Here: Tax Cuts and Historic Downturns

In the mid-1990s, North Carolina's policymakers enacted a series of tax changes that moved the state effectively to pay-as-you-go financing for its UI system (See Box 1). These tax cuts undermined the adequacy of the trust fund and brought the state's unemployment insurance trust fund levels below safe levels recommended by the best evidence—just before the first recession of the 2000s hit. Because trust fund levels were too low to pay out unemployment benefits and employer contributions were required to fund the program, employers made greater contributions as a share of total wages (1.6 percent) in 2009 than they did in 2000 (0.6 percent). The lowest tax paid by employers was 0.2 percent in 1996—a year when the economy was better and the state should have been building up the trust fund.[8]

Indeed, the balance of the UI trust fund fell precipitously in the 1990s, leaving the state's unemployment insurance system ill-prepared for the current recession. The full loss to the UI trust fund depends upon various factors related to the structure of tax schedules and the labor market, but it is possible to approximate the impact by looking at the average tax rate in North Carolina versus the nation. If North Carolina had required contributions from employers at the national average tax rate from 1990 to 2004, the UI Trust Fund would have had $2.8 billion in 2004, erasing the current solvency issues. By 2004, the balance in the state's trust fund was just $23 million with an average high cost multiple of 0.38, well below the recommended level of 1.0. (SEE FIGURE 2)

By 2000, North Carolina had already reached below the minimum safe level recommended by economists and experts of what a trust fund would need to be able to pay out benefits in a downturn. One measure of solvency, the average high cost multiple, compares the amount of UI benefit payments in a previous twelve-month period to trust fund balances. As the graph below demonstrates, the average high cost multiple has not been above the recommended level of 1 since the start of the decade.

Figure 2: NC Trust Fund Solvency has declined precipitously since the 1990s



In addition to short-sighted tax cuts, the failure of payroll to rebound after the 2001 recession[9] was in part to blame for North Carolina's precarious position entering the last recession. In addition, North Carolina has lost employers covered by the unemployment insurance system in recent years. As of March 31, 2010, there were 197,956 covered employers in the state, compared to 198,849 at the end of the prior quarter and 202,374 at the end of March 2009.[10] This loss of covered employers is a result of the economic transformation that North Carolina continues to experience with the loss in manufacturing particularly.[11]

Because of all of these factors, North Carolina, like 26 other states, has borrowed from the federal government to sustain the day-to-day delivery of unemployment benefits.[12]

The Current UI System

The responsibility of financing unemployment insurance is shared by the federal government and the state. Both levels of government levy payroll taxes on employers to fund UI. The first $7,000 in wages paid to a worker by an employer is subject to a federal tax of 6.0 percent (reduced from 6.2 percent last year); but because the federal government gives employers credit for state UI taxes paid, the net federal tax rate will be 0.6 percent in 2012. These dollars are used to operate the national UI system, maintain the loan fund for states, pay part of extended benefits, and help support state administrative costs.

Employers in many states that borrowed from the federal government to pay unemployment benefits saw their federal payroll taxes increase last year. After the second year of borrowing, employers in states with outstanding federal loans are required to pay higher federal taxes to repay the principal. This tax increase is called a

FUTA (Federal Unemployment Tax Act) credit reduction. For most borrowing states, employers saw their tax rates on 2011 wages increase by 0.3 percent or $21 per worker (payable in January 2012) because their FUTA credit for taxes paid was reduced. The credit will drop by an additional 0.3 percent for a total of 0.6 percent per worker for 2012 wages (payable in 2013). North Carolina was one of 21 states that had a FUTA credit reduction for 2011. According to analysis by the Division of Employment Security, the FUTA credit reduction would need to be in place until 2018 in order to address the outstanding loan balance.[13] That would mean that in 2018 the FUTA credit reduction would amount to $210 per worker, a 233-percent increase from the current $63.[14]

North Carolina employers also pay state UI taxes, which are used exclusively to fund unemployment insurance benefits. The taxes paid by an employer vary, at least in part, on that employer's experience using the UI system. In theory, an employer who dismisses more employees should pay more in taxes than one who dismisses fewer employees. An employer's experience rating is based on how many people the employer dismisses who then receive UI benefits; a higher rating results in a higher tax rate. Because no experience-based system is perfectly efficient, there are additional charges shared collectively by every covered employer.

North Carolina assesses a variable, experience-rated payroll tax on the first $19,000 in wages paid by a covered employer to a worker. This wage base changes every August. The actual tax rate depends on the health of the UI trust fund's balance and the employer's experience rating. Nominal tax rates vary from zero percent to 5.7 percent, depending on which of the nine authorized tax schedules is in effect.

Employers have already begun paying increased unemployment taxes as a result of the state's trust fund becoming insolvent. That is because policymakers put in place an

Figure 3: NC Unemployment Insurance Tax Changes, 1992-2000

1992	• Temporary repeal of 1987 20% surcharge
1993	• Standard contribution rate for new employers reduced from 2.7% to 2.25% • Contribution rate for positive-rated accounts reduced by 30%
1994	• Standard contribution rate for new employers reduced from 2.25% to 1.8% • Contribution rate for positive-rated accounts reduced by 50% in any year when trust fund balance exceeds $800 million
1995	• Contribution rate for positive-rated accounts reduced by 50% in any year when trust fund balance exceeded $800 million and fund ratio was less than 5%; reduced 60% when trust fund balance exceeded $800 million and fund ratio was more than 5% • 0% contribution rate given to accounts with positive-rating of 5% or more (i.e. lowered minimum rate) • Reduction in % of annual average wages used to calculate taxable wage base – from 60% to 50%
1996	• Allowed businesses with positive balance to pay no tax and lowered new business rate from 1.8% to 1.2%
2000	• Contribution rates for all accounts reduced by 20% for 2000 and 2001 • 0% Contribution rate given to accounts with positive-rating of 4% or more

SOURCE: NC Employment Security Commission important policy, the minimum safe-level tax, which kicks in when the trust fund balance falls below a safe level. This has allowed North Carolina to make interest payments on the loan balance to date.

In 2011, the average employer tax rate was 1.93 percent of taxable wages. On total wages, the average employer tax rate was far lower—0.87 percent.[15] The estimated employer contribution per covered employee was $336, which represents $0.009 for every dollar of wages paid.[16] At the minimum rate, the contribution per covered employee is $47, while at the maximum rate the contribution per covered employee is $1,347.[17] Analysis by the US Department of Labor finds that the state's adequate financing rate is 3.09 percent or nearly 50 percent higher than the current tax rate.[18]

WHO IS ELIGIBLE FOR UNEMPLOYMENT INSURANCE?

Unemployment insurance is only available to workers who have lost their jobs due to no fault of their own. To receive unemployment insurance, unemployed workers must register at a Division of Employment Security office, by phone or through the Internet. Claims are then evaluated against monetary and non-monetary criteria. First, a worker must have earned a certain amount of money during a specified base period. North Carolina typically requires a worker to have earned a minimum of six times the weekly insured wage ($4746 in 2011) within a one-year period. Second, a worker must demonstrate consistent labor force engagement and be able to work, available for employment and seeking a job.[19]

Approaches to UI Financing

Two distinct approaches to financing unemployment insurance have evolved over the program's history. As mentioned above, the original intent of the program was to follow an approach of forward-financing. Under such an approach, employers contribute to the trust fund in good times at an adequate level so that when bad times occur benefits can be paid out and fund levels can be recovered when good times return.

By contrast, the pay-as-you-go approach to UI financing requires employers to pay higher UI taxes as claims rise during a downturn and as such have lower UI taxes and trust fund reserves in good times. The states that have taken this approach explicitly are Pennsylvania, Texas and Illinois, while other states have moved in this direction in practice. A variation on pay-as-you-go is flexible financing, which relies on targets to trigger changes in tax levels so that the trust fund balance can be maintained. An estimated 30 states have some form of flexible financing, including North Carolina. The theoretical basis for pay-as-you-go financing is that inefficiencies are present in large trust fund balances because of the opportunity cost of those dollars to the economy.[20]

Evidence is mounting that the financial strain of pay-as-you-go approaches to UI financing make the system unsustainable in downturns. This is because employers are required to pay higher taxes in difficult economic times, and there is often political pressure to reduce the cost of the program by cutting benefits to jobless workers, thereby undermining the effectiveness of the program's wage-replacement function.[21]

Strengthening the UI System

Strengthening the fiscal health of the UI system is fundamental to strengthening the overall function of the program to minimize the risk of significant income loss due to job loss and the downward pressure that places on overall consumer spending and the economy. Fiscal health will require that North Carolina pay down the existing loan balance and put in place a forward-financing system that can best support the system in good times or bad. Such efforts should be focused on achieving future adequacy by ensuring the full and equitable participation of employers.

The immediate challenge of paying down the current debt is likely best served by addressing long-term solvency. The current crisis took at least a decade to reach, and solving it will take time. While solutions like bonding the current debt in the private market have been discussed, it appears that the costs and structure of such deals would not provide sufficient savings to suggest they are good options.[22] Therefore, strengthening the UI system should be seen as a long-term endeavor.

Future Adequacy

North Carolina's unemployment insurance system was inadequate to weather the most recent economic downturn, but it had been in a precarious position well before the latest recession. The five-year benefit cost—benefits paid out over the last five years as a percent of total wages—was 3.08 percent in 2011, and yet the average tax rate in North Carolina was 0.87 percent.

To achieve adequacy it is critical that North Carolina ensure a greater share of the total wages in the economy are part of the taxable wage base. This allows for the system to truly collect adequate contributions relative to the demand that could occur from workers involuntarily losing their jobs. North Carolina's current taxable wage base is pegged to 50 percent of the state's average annual wage.

Full Participation

North Carolina's unemployment insurance system was designed to protect the economy, and that means workers and businesses alike. Full participation by employers is critical to ensuring the system is effective and the cost of the shared benefits of this insurance is widely shared.

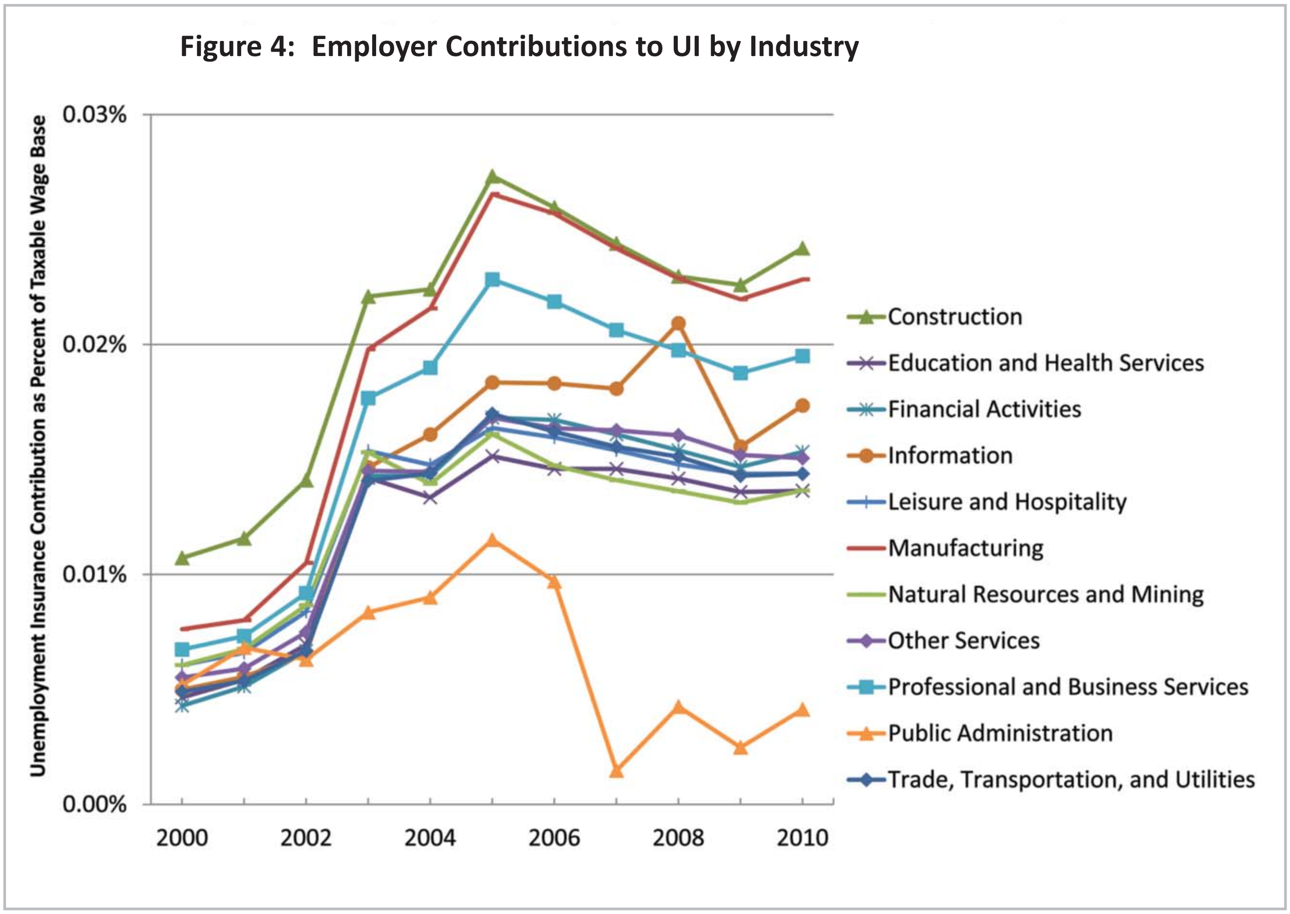
Currently, there are 19,009 employers who pay zero percent. While these employers have not laid off workers, they benefit from the broad economic impact of a strong unemployment insurance system. The majority of states require some contribution from all employers in a downturn.

Equitable Contributions

North Carolina's unemployment system uses an experience rating system that requires greater contributions from those businesses who have most utilized the system because of greater numbers of layoffs. The tax-rate range and increments between them can ensure that employers truly pay the costs associated with their experience of layoffs; for example, a smaller increment between rates creates a closer connection between the employer's experience and his payment to the system.[23]

The challenge for North Carolina is that the contributions required are not always closely aligned with experience. When this happens there is evidence that firms can engage in temporary layoffs given that there isn't a strong financial disincentive to have more experience with the unemployment insurance system.[24] Thus researchers have found that experience rating can improve employment, wages and production.[25]

The challenge of alignment is particularly true at the minimum and maximum levels of the experience rate. Firms can reach the maximum rate, and may do so early and still lay off workers with no impact on their contributions, while employers at the minimum rate will continue to contribute even if their workers never claim unemployment insurance. The result of weak experience ratings is that industries like construction and



SOURCE: Quarterly Census of Employment and Wages, Bureau of Labor Statistics.

manufacturing are subsidized through the unemployment insurance system.[26] While from the graph above it is clear that these industries in North Carolina are making significant contributions to the system, there is broader research to suggest that imperfect experience rating can decrease the stability of employment.

There are 18,931 employers in North Carolina who are operating with a negative reserve account. This means they have not contributed to the system at a level adequate to match the draw of benefits from the workers they have laid off. For these employers, their cumulative employee reserve account is negative $2.1 billion. There are also 11,423 inactive employers with negative balances of $452 million in their employer accounts.[27] Such a situation suggests that these employers are not paying in line with their experience with the system.[28]

Why Cutting Benefits Can't Help Us

Fundamental to the purpose of the unemployment insurance system is maintaining consumer demand so the economy can stabilize in periods of downturns. The way this is achieved is by ensuring that workers have temporary wage replacement so they can meet basic needs and remain connected to the labor force. The norm, established nearly fifty years ago, of what that translates to in terms of monetary benefits has centered on one-half for four-fifths—the replacement of one-half the earnings for four-fifths of unemployed workers.

The U.S. Advisory Council on Unemployment Compensation issued recommendations in the mid-1990s that "each state should replace at least 50 percent of lost earnings over a six-month period, with a maximum weekly benefit amount equal to two-thirds of the state's average weekly wages."[30] A strong body of research finds that such a target balances concerns over

WHEN WOULD NC ACHIEVE SOLVENCY?

PROPOSAL	YEAR TRUST FUND ACHIEVES SOLVENCY
No law changes	2018
Incremental wage base increase, new rate schedule, 2.7% standard beginning rate, eliminate 0% contribution rate	2017
Incremental wage base, new rate schedule, 2.7% standard beginning rate, eliminate 0% contribution rate, solvency surcharge	2015

IN WINTER OF 2011, the Division of Employment Security (then called the Employment Security Commission) convened a tax policy committee to consider various proposals that could achieve solvency in the trust fund. With the available data on employers' experience, projections on benefit payouts and tax collections, the DES identified and analyzed a number of proposals to achieve solvency.

Solvency is achievable. However, achieving solvency sooner will require greater contributions per employee. There could certainly be a benefit to this calculation given the tightening of business cycles and the need to be on sounder footing ahead of the next recession. In fact, if the next downturn occurs in line with the post-World War II average business cycle duration, calculations suggest it will begin in March 2014.[29] Reaching just a zero balance before the next recession will do little to improve the prospects of avoiding future debt to finance the program.

the potential impact of benefit levels on unemployment duration with the very real basic needs of workers without jobs.[31]

Connection to the labor force is critical to maintain in a job market with too few jobs. As is evidenced by the experience in North Carolina over the Great Recession, when labor force participation declined by 1 percent and the working-age population increased by 5 percent, it is critical that workers stay engaged in the economy through work. Recent studies have found that UI benefits encourage recipients to stay in the workforce and actively search for a job, which may increase the share of jobless workers who are later re-employed.[32]

The modest average payment in North Carolina of $290 per week is still inadequate to meet the basic needs of a family of one worker and two children: each month $1110 would go unpaid according to analysis of the Living Income Standard. For workers, unemployment insurance payments on average represent just 37 percent of their previous earnings.

A comparative look across states at wage levels is required to understand why benefit levels are at certain levels in North Carolina relative to neighboring states. The distribution of wages in North Carolina represents higher earnings by nearly $5 per hour at the 80th percentile than in South Carolina.[33] Additionally, nearly a third of North Carolina's workforce had earnings in the prior 12 months that could have qualified them for maximum benefits according to 2010 data.[34] As a result of the effort to achieve wage replacement, the very nature of maximum benefit levels reflects wage conditions in the labor market overall.

Changes to Benefits

As part of discussions about addressing the solvency crisis, there has been discussion of changing the amount of benefits paid out. Such changes either to benefit eligibility or levels must take into account the wage-replacement function of the unemployment insurance system and its role in supporting struggling workers, and any changes should make significant contributions to addressing the solvency of the trust fund.

Under the American Recovery and Reinvestment Act of 2009, North Carolina received a series of incentive payments because the state had implemented various policy changes to achievea modern unemployment insurance system. Eliminating these modernizing provisions would contribute little to the overall solvency of the trust fund, and no state to date has moved to reduce these features. In total, these features represented $42 million and would contribute roughly 1.6 percent toward the trust fund loan balance.[35]

Another change to benefits that has been suggested is to reduce the average or maximum benefit levels to align with other southeastern states, particularly South Carolina. As noted above, this type of alignment doesn't follow from the evidence around the compositional differences in the workforce between North Carolina and South Carolina. However, if North Carolina were to reduce, for example, the average benefit payment to South Carolina's level, the fiscal impact would be a reduction in benefits paid out by $196 million. This would also reduce the wage-replacement function of the payment to just 30 percent of the average wage in North Carolina.

A reduction in the maximum benefit level is more difficult to calculate but would likely impact the workers in higher-wage industries, such as finance, bio-technology and many other industries North Carolina has invested significant dollars to attract to the state. According to Division of Employment Security calculations, reducing the maximum weekly benefit amount from 66.7 percent to 60 percent of the average weekly insured wage would lower the maximum benefit from $522 to $425. If this were the only change made, solvency would not be achieved until 2018.[36]

Finally, it has been suggested that North Carolina reduce the duration of state unemployment insurance payments from 26 to 20 weeks. The fiscal impact of such a change would vary significantly across economic periods and could range from $128 million per year (using an estimate from 2003 to 2007) to $237 million (in a downturn like 2011).[37] Such savings would represent 4.7 percent to 8.7 percent of the trust fund loan balance.

At the same time, however, such a move would harm workers who have been unemployed the longest and are likely facing additional structural barriers to re-employment. Workers who have been out of work for long periods are more likely to be older, from communities of color and from industries in structural decline.

The solution to North Carolina's solvency crisis does not rest with cutting benefits and further undermining the system's function replacing lost wages and ensuring the economy in a downturn.

Additional Opportunities

The simultaneous challenge to addressing the trust fund's solvency is the creation of good, quality jobs to fill the state's half-million-jobs deficit. As jobs return, re-employment services that work will be critical and require investments: training for new industries at community colleges, one-on-one career counseling and additional supports for workers taking on lower-wage work.

There is also an opportunity for policymakers to consider the changing nature of the labor market and consider the ways in which the classification of employees has impacted collection of UI taxes. Employer misclassification of their employees as independent contractors reduces payments into various social insurance programs, including the unemployment insurance system. A review by the U.S. Department of Labor in 2000 found that underreported UI tax revenues due to misclassification ranged from 0.26 percent to 7.46 percent of total UI tax collections.[38]

Additionally, ahead of the next downturn, North Carolina policymakers should put in place a work-sharing program to increase the attachment of workers to their jobs and reduce the full payments of unemployment insurance benefits by encouraging a reduction of hours rather than layoffs. Such a move would reduce pressure on the unemployment insurance system during a severe economic downturn and allow employers and workers to benefit from staying on the job longer.

Conclusion

The challenges of North Carolina's unemployment insurance trust fund will take time to address completely. A recommitment to ensuring the system works well for the state's economy will require that policymakers adopt a forward-financing approach that adequately funds the system in good times by ensuring equitable and full participation by employers and replaces wages to effectively support working families and their ongoing participation in the economy and labor market.

RECOMMENDATIONS

Do no harm to the wage-replacement function of unemployment insurance. Fundamental to the purpose of the unemployment insurance system is maintaining consumer demand so that the economy can be stabilized in periods of downturn. Unemployment insurance payments on average represent just 37 percent of workers' previous earnings. Maintaining an effective wage-replacement level and striving to achieve the target of 50 percent should be priorities.

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. Increasing the taxable wage base from this current level of 50 percent 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.

Reform the experience-rating system to better align taxes paid with benefits from the unemployment insurance system.

- 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; all other states have higher rates. Raising the beginning rate to some level near 2.7 percent, as the Division of Employment Security recommends, 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 experience-rating system is complex, and an assessment of North Carolina's system would require modeling based on Division of Employment Security data, but an effort to closely align the range of contribution rates with national practice is important and should be pursued. Currently, 34 states have maximum contribution rates higher than North Carolina.[39]

Strengthen re-employment services and establish work-sharing programs for future downturns. As jobs return, it is critical that North Carolina policymakers invest in re-employment services that work: training for new industries at community colleges, one-on-one career counseling, and additional supports for workers taking on lower-wage work. Additionally, ahead of the next downturn, North Carolina policymakers should put in place a work-sharing program to increase the attachment of workers to their jobs.

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