United States General Accounting Office 136429

GAO

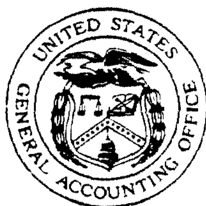
Testimony

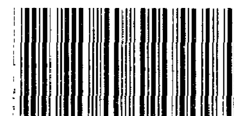
For Release
on Delivery
Expected at
9:30 a.m. EDT
Thursday
July 7, 1988

Unemployment Insurance: Issues Relating to Reserve Adequacy and Trust Fund Solvency

Statement of
William J. Gainer, Associate Director
Human Resources Division

Before the
Subcommittee on Employment and Housing,
Committee on Government Operations
House of Representatives





042816

GAO/T-HRD-88-23

SUMMARY OF GAO TESTIMONY BY WILLIAM J. GAINER ON UNEMPLOYMENT INSURANCE ISSUES RELATING TO RESERVE ADEQUACY AND TRUST FUND SOLVENCY

The Unemployment Insurance (UI) system is the federal government's major means of providing income maintenance assistance to the unemployed. The majority of state UI trust funds do not have adequate reserves, and the proportion of the unemployed receiving benefits is near record low levels. The next recession threatens a repeat of the experience of the early 1980's with widespread trust fund insolvency and massive federal borrowing by state trust funds to pay benefits.

INADEQUATE RESERVES INCREASE STATE BORROWING Since 1970, the national UI system has faced a growing problem of inadequate reserves. As of December 1987, after years of strong economic expansion, only 4 states had reserves sufficient to pay recession-level benefits based on the most commonly used measure of financial adequacy. The decline in reserve adequacy foreshadowed the need for massive federal loans in the last 15 years. Since 1972, states have borrowed about $30 billion to pay benefits, most of it in the last 7 years, essentially abandoning the system's traditional self-financing feature.

DECLINE IN THE BENEFIT RECIPIENCY RATE The proportion of the unemployed receiving benefits has drifted downward since 1950 to the point where the system's role in stabilizing the economy may have been reduced. As of May 1988, only 31 percent of the unemployed received regular UI benefits, significantly less than the 41 percent receiving benefits during the 1970's.

FEDERAL POLICIES HAVE ENCOURAGED CUTS IN ELIGIBILITY The recipiency rate has declined for many reasons, including shifts in workforce demographics and national industrial composition. However, 1980's federal loan policies also contributed to the recipiency decline because, to improve solvency, many states cut benefit costs by reducing claimant eligibility.

CONCLUSION Federal loan policies have not resulted in states accumulating reserves sufficient to withstand another recession without substantial new federal borrowing. During future recessions, states may respond in a similar manner by reducing benefit eligibility if the system is not changed. Congress could reestablish the system's self-financing feature by providing states incentives to build adequate reserves during periods of low unemployment, rather than simply accumulating enough reserves to repay current loans. However, because current federal policy has had the effect of encouraging a reduction or withdrawal of benefits to many workers, Congress may wish to craft any measure to improve reserve adequacy in a manner which does not further erode benefit eligibility.

Mr. Chairman and Members of the Subcommittee:

I am pleased to be here today to share with you some results from GAO's analysis of issues facing the federal-state Unemployment Insurance (UI) system. In particular, I will discuss the general trend in the financial health of state UI trust funds over the last 20 years, and the actions taken by states during the 1980's in response to recessionary conditions and to new federal loan policies. I will also comment on the relationship between these events and the long term decline in the proportion of the unemployed who receive benefits. Our major conclusions are as follows:

- There has been a long term decline in the adequacy of UI trust fund reserves.
- This decline in reserve adequacy contributed to the massive borrowing by state trust funds to pay benefits during the 1980's.
- Concurrently, there has been a decline in the proportion of the unemployed receiving benefits, which, though caused by many factors, was likely influenced strongly by changes in federal policies that encouraged states to cut benefit eligibility.
- Future recessions threaten a repeat of the pattern from the early 1980's; inadequate reserves, insolvency and massive federal borrowing by state funds, and another reduction in the proportion of the unemployed receiving benefits. This implies the potential further weakening of the UI system's anti-recessionary effectiveness.

Before elaborating on these points, I would like to provide some pertinent background on the characteristics of the Unemployment Insurance system.

BACKGROUND

The Unemployment Insurance (UI) system is the federal government's major means of providing income maintenance assistance to the unemployed. The system's primary objectives are to provide employees with temporary and partial insurance against income loss resulting from unemployment and to assist in the counter-cyclical stabilization of the national economy during economic downturns. State payroll taxes on employers finance regular state benefits. In addition, the federal government levies a payroll tax to finance state and federal UI program administration and other activities. In 1986, the trust funds of the 50 states, the District of Columbia, Puerto Rico and the Virgin Islands paid about $16.0 billion in regular state

benefits to more than 8.5 million unemployed workers and collected about $20.3 billion in employer taxes and interest. The UI system has traditionally operated on a self-financing principle--reserves accumulate during periods of economic expansion and are used to pay benefits during periods of economic decline.

ADEQUACY OF TRUST FUND RESERVES

To determine whether state trust fund reserves are being maintained at levels sufficient to pay benefits during times of increased unemployment, GAO examined trends in the most commonly used measure of financial adequacy, known as the "High Cost Multiple. This measure compares current reserves to peak historic benefit payouts and is essentially a measure of how long recession-level benefits could be paid from current reserve balances. In the past, the Department of Labor recommended that states voluntarily adopt a standard of maintaining reserves equal to a multiple of at least 1.5--equivalent to requiring that reserves be available sufficient to pay recession-level benefits for one and a half years.

GAO Adequacy of Trust Fund Reserves

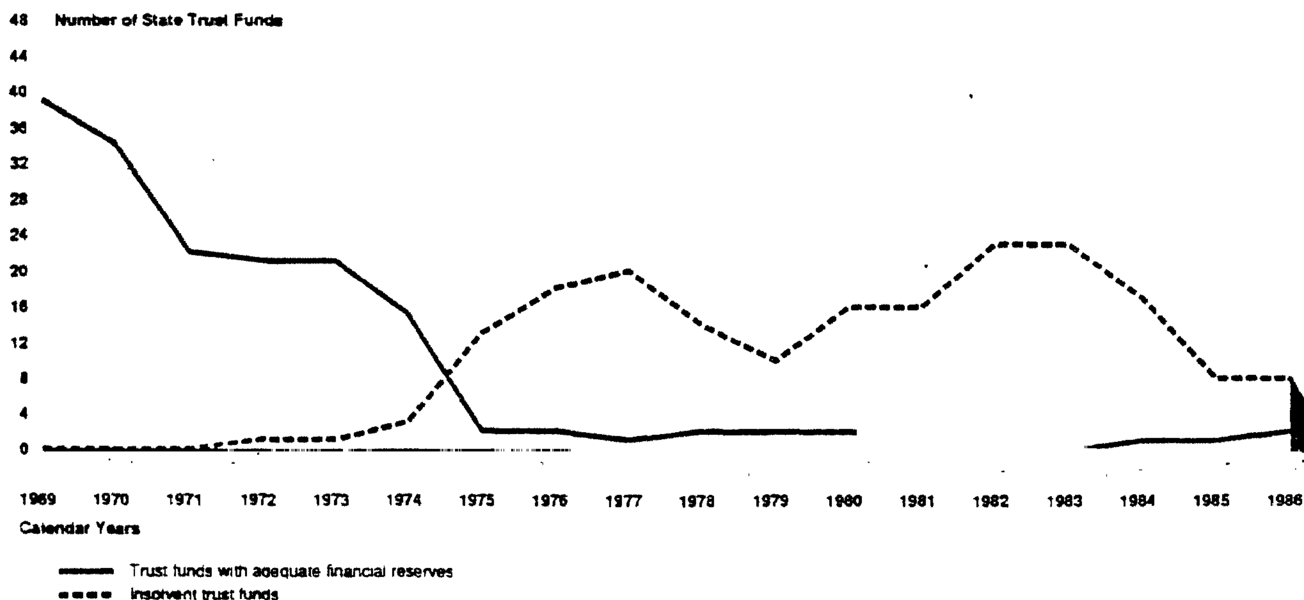
- Ability to Pay Recession-level Benefits Has Declined
  - 39 Funds Adequate in 1969
  - 4 Funds Adequate in 1987
- Current Reserves Are Inadequate
  - Less than 8 Months of Recession-level Benefits
- Inadequate Reserves Led to Massive Borrowing Since 1970
  - 31 Trust Funds Insolvent
  - $30 Billion in Federal Loans

Using this standard, GAO found that the system's ability to pay benefits from available reserves has declined significantly over the last three decades, especially since 1970. Although the aggregate High Cost Multiple registered an annual average of 2.1 between 1954 and 1969, indicating a strong financial position, it fell during the 1970's and became negative in 1982 before recovering. As of the end of 1987, the system's multiple was 0.66--meaning that reserves on average were sufficient to pay benefits about 8 months without additional revenue, much shorter than the average postwar recession of 12 months and much less than the 18 months recommended by Labor in 1981.

As for individual trust funds, 39 states had adequate trust fund reserves in 1969 (meeting the 1.5 standard), but only 2 states had adequate reserves in 1975 (See Figure 1). As of the end of 1987, only four programs--Hawaii, Mississippi, South Dakota and the Virgin Islands--had funds with adequate reserves. Using a less stringent 1.0 standard does not significantly change the qualitative conclusion reached from using the higher standard. Only 15 state funds were found to have multiples above 1.0 as of the end of 1987, down from 51 jurisdictions in 1969.

The long term decline in reserve adequacy foreshadowed the widespread state trust fund insolvency and borrowing that began in the 1970's. The number of insolvent state trust funds increased from 1 in 1972 to 13 in 1975 and to 23 in 1982 and 1983. During the last 15 years, state trust funds borrowed nearly $30 billion from the federal government, most of it since 1981. States with the most severe trust fund difficulties have generally been in regions where economic activity has been depressed as compared to the nation in general.

Figure 1: Reserve Adequacy and Solvency of State UI Trust Funds, 1969-86



During the last 5 years, economic growth and lower unemployment have led to a reduction in the number of insolvent state funds. As of the end of 1987, there was only one insolvent trust fund, Texas, down from 8 at the end of 1986. However, none of the other seven funds insolvent at the end of 1986 had accumulated adequate reserves by the end of 1987. All had High Cost Multiples of .26 or less.

Because of sustained economic growth, aggregate UI reserves have increased to an historic high of $23.2 billion as of December 31 1987. However, despite this growth, many state trust funds remain vulnerable to an economic downturn. Our analysis of trends in trust fund reserves using Department of Labor simulations suggests that using the standard 1.5 High Cost Multiple, trust fund reserves will not reach adequate levels even under conditions of relatively strong economic growth over the next five years. The simulations also show that a moderate to severe recession significantly reduces reserves and increases the number of insolvent trust funds to as many as 17.

CAUSES OF THE DECLINE IN RESERVE ADEQUACY

The decline in reserve adequacy has been caused by several factors, including (1) the high unemployment generated by three major recessions during the last 15 years, (2) the creation of an extended benefits program that was not funded by additional state revenues, and (3) the relative imbalance in some states between increasing expenditures and static revenues when benefit payments are indexed to inflation and taxes are not.

GAO

Causes of Decline in Reserve Adequacy

- Higher Unemployment Since 1973
- Extended Benefits Not Funded
- Many States Tied Benefits to Inflation
- Revenues Not Indexed

LOWER PROPORTION OF UNEMPLOYED RECEIVING UI BENEFITS

The proportion of the unemployed who are drawing UI benefits has declined significantly over the past 35 years. In 1952, almost 55 percent of unemployed civilian workers were receiving UI benefits; by 1980 less than 44 percent were receiving benefits, and the ratio declined further, reaching 29 percent in 1984 before rising slightly during the last three years. As of May 1988, 31 percent of the unemployed were receiving benefits.

GAO

Proportion of Unemployed Receiving Benefits Declining

- 43% Received Benefits in 1960's
- 31% Received Benefits Since 1985
- Causes
  - Workforce Demographics Changing
  - Service Sector Growing
  - Federal Policies Encouraging Solvency

The decline in the proportion of the unemployed receiving UI benefits suggests a reduction in the UI system's effectiveness in stabilizing the economy and in mitigating the effects of income loss suffered by the unemployed. One analyst found that the decline in regular UI program benefit recipiency alone has reduced the anti-recessionary stimulus of regular UI benefits by 25 percent. Other studies conclude that the decline in recipiency appears to have eroded the program's effectiveness in reducing the income loss suffered by the unemployed.

Major contributors to this trend are:

Changing Workforce Demographics--A demographic shift toward a younger and more female workforce caused at least part of the decline in the proportion of the unemployed receiving benefits. Compared to adult males, smaller proportions of young and female unemployed qualify for benefits. Thus, as their fraction of the unemployed has increased, the portion receiving benefits has declined.

The Growth In Service Sector Employment--The steady post war employment transition from goods-producing sectors to service sectors has also tended to reduce the proportion of the unemployed receiving benefits. Historically, a smaller proportion of unemployed workers in service sector industries receive benefits compared to those in other industries. This is likely related to the greater prevalence of part-time workers who often do not qualify for benefits.

State UI Program Changes--State efforts reducing benefit duration, tightening up benefit eligibility and other actions reduce the proportion of the unemployed receiving benefits by reducing the number of workers eligible.

Other factors thought to explain the decline in the proportion of the unemployed receiving UI benefits include the growth in long-term unemployment and federal legislative changes such as reducing UI benefits if a worker is also receiving pension benefits which are believed to have led to a lower rate of benefit application.

STATE LEGISLATIVE ACTIONS REDUCE THE PROPORTION OF THE UNEMPLOYED RECEIVING BENEFITS

States enacted program changes in the 1980's that reduced maximum benefit duration, tightened eligibility requirements, or took other actions that reduced the proportion of the unemployed receiving benefits. The cumulative effect of these state actions is significant. A Department of Labor commissioned study by Mathematica Policy Research has shed some light on the impact of these changes. Despite some statistical constraints, Mathematica estimated that changes in state UI laws and administrative practices have contributed to between 30 and 40 percent of the decline in benefit receipt between 1980 and 1986.

Among the actions states took during the 1980's that have reduced the percentage of unemployed workers receiving benefits are:

Reducing the Duration of Benefits-- Seven states reduced the maximum duration of regular benefits available to claimants.

Tightening Eligibility Standards-- States require that claimants have some minimum earnings or number of weeks worked or some combination of these prior to becoming unemployed to qualify for benefits. For example, a state may require a minimum earnings total during a 1-year period to qualify for benefits with the added requirement that total annual earnings be equal to 1.5 times the earnings in the highest quarter during that year. When states increase the total amount of earnings or minimum work time necessary to qualify for minimum benefits, fewer unemployed workers qualify for benefits. Since 1981, 18 states tightened their monetary eligibility formulas.

Increasing Penalties for Benefit Disqualification-- All states disqualify some claimants who quit their jobs, are fired for misconduct, or refuse suitable employment. Penalties for claimant disqualification often specify a period of ineligibility and require new employment to reestablish eligibility. Since 1981, 31 states increased disqualification penalties.

Many of the jurisdictions which enacted at least one of these provisions experienced trust fund difficulties. Between January 1981 and January 1987, 44 UI programs, 30 of which had borrowed federal funds at least once, either reduced maximum benefit duration, tightened eligibility requirements, or took other actions which reduced the proportion of the unemployed receiving benefits.

1980'S FEDERAL LOAN POLICIES INFLUENCED STATES' ACTIONS

Federal loan policy changes during the 1980's, while encouraging states to repay federal loans, also caused at least some states to take actions reducing the proportion of the unemployed receiving benefits. These policy changes include:

Interest on New Federal Loans--During the 1970's federal loans to state trust funds were interest free. However, in 1981, Congress approved interest charges of up to 10 percent on loans not repaid in the same fiscal year in which they were made.

Employer Tax Penalties--Federal law provides for the imposition of direct employer taxes or so called "penalty taxes" which are essentially mandatory loan payments in states failing to repay loans in a timely manner. During the 1970's, Congress permitted relatively lenient conditions for states with delinquent loans to defer penalty taxes. Between 1975 and 1979, all 19 states with delinquent loans received a penalty tax deferral of at least 1 year, and most received multiple year deferrals. These deferrals expired in 1980, resulting in significant increases in state penalty tax payments.

Financial Incentives for States to Increase Taxes and Reduce Benefits--In the 1983 Social Security Amendments and other laws, the Congress provided incentives--reduced or deferred interest payments and penalty tax deferrals--for states with outstanding federal loans to take actions to increase revenues and limit expenditure increases. To qualify, states were required to amend their UI laws to improve program solvency by both raising UI taxes and reducing benefit costs. Ten state trust funds qualified for one or more of the solvency incentives during the early 1980's.

GAO

Federal Policies Encourage Solvency/Impact Benefits

- Congress:
  - Enforced Penalty Taxes (1980)
  - Charged Interest on Loans (1981)
  - Enacted Solvency Incentives (1983)
- States Responded By:
  - Repaying Loans
  - Raising Employer Taxes
  - Cutting Benefits Costs

In response to the new federal policies, many states increased UI taxes but also took legislative actions reducing the proportion of the unemployed receiving benefits. As a result, voluntary loan repayments rose from $362 million in fiscal year 1982 to almost $2.6 billion in fiscal year 1983, a seven-fold increase. However, although these loan policies have had the intended effect of expediting state repayment of federal loans, they have not encouraged states to accumulate sufficient reserves to avoid future borrowing. The combination of current federal loan policies and the generally inadequate level of reserves maintained by most states raises the possibility that the next

recession will lead to another round of large borrowing and further reductions in benefit eligibility as states try to avoid borrowing or repay their loans as quickly as possible.

MATTERS FOR CONSIDERATION

The failure of most state Unemployment Insurance trust funds to maintain adequate reserves has eroded the UI system's feature of state self-financing and has increased the potential for massive borrowing from the federal government. Should the Congress wish to restore the self-financing feature and reduce the potential for significant state borrowing in future recessions, it should require states to build adequate trust fund reserves during periods of low unemployment. By redesigning federal policies, Congress could provide states with incentives to build adequate reserves to avoid future borrowing rather than simply encouraging them to accumulate enough reserves to repay current loans.

One option, consistent with current program mechanisms, would be to establish a standard for the level of reserves to be maintained by state UI trust funds. The implementation of such a standard could include a grace period for compliance based on variations in a state's current and historical economic conditions. The standard could be enforced using a mechanism analogous to the penalty tax currently levied on employers in states with delinquent trust fund loans. Resulting revenues would be deposited into the state trust fund until the reserve standard was met.

Furthermore, because current policy regarding federal lending to state trust funds has had the effect of encouraging a reduction or withdrawal of benefits to many workers, Congress may wish to craft any measure to improve reserve adequacy in a manner which does not further erode benefit eligibility.

A related consideration is that the financial health of state trust funds varies, in part, because of differences in the patterns of regional economic activity. The Congress may wish to consider program changes which would help offset the fiscal burden that falls on states with chronically high unemployment rates. For example, the federal unemployment insurance tax could be increased somewhat and the additional proceeds used to aid those states with particularly severe unemployment conditions.