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Unemployment Insurance: Administrative Funding Likely a Growing Problem

Statement of
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Before the
Subcommittee on Human Resources
Committee on Ways and Means
House of Representatives

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SUMMARY OF GAO TESTIMONY BY WILLIAM J. GAINER ON UNEMPLOYMENT ISSUES RELATING TO ADMINISTRATIVE FINANCING REFORM

The Unemployment Insurance (UI) system is the federal government's major means of providing income maintenance assistance to the unemployed. State payroll taxes on employers finance benefits paid to unemployed workers. Employers also pay a federal tax from which the Department of Labor allocates funds to states for administration of the UI program.

UNDERFINANCING OF STATE'S ADMINISTRATIVE COSTS Although the federal tax was envisioned as the sole source of funding for the costs of administering the UI program, this premise has been eroded during the 1980s. Federal spending for state UI administration has been consistently less than Labor's estimate of state costs because of budgetary and appropriation cutbacks.

STATE FINANCIAL AND MANAGERIAL ADJUSTMENTS States have increasingly used their own funds to help cover the costs of UI administration. For example, 33 states provided a total of about $54 million in supplemental funds to cover the cost of administering the UI program in fiscal year 1987. In addition, managerial adjustments--such as increased automation, greater use of mail claims, and jointly locating additional UI offices with Employment Service program activities--were made to contain costs and maintain service.

DESPITE GROWTH, TRUST FUND RESERVES REMAIN INADEQUATE As GAO has previously reported, most state UI trust funds have inadequate reserves. Despite continued economic expansion, as of December 1988, only four states had reserves sufficient to pay recession level benefits. This is based on the most commonly used measure of financial adequacy, the High Cost Multiple. In the aggregate this measure has increased only marginally from .66 in December 1987 to .78 in December 1988, meaning that there are about 10 months of recession level benefits on reserve.

CONCLUSION Federal underfinancing of state administrative costs has been in part offset by state financial adjustments and managerial changes. However, lower UI workloads and other factors have led to a decline in the number of experienced staff, including the part-time/temporary staff historically relied on in times of increased unemployment to meet increased UI workloads. Consequently, should workload suddenly rise, disruptions in service or significant increases in claims processing errors could occur, because states would be unable to get adequately trained staff processing claims as quickly as necessary. In addition, during the next recession inadequate state benefit trust fund reserves could threaten a repeat of the experience of the early 1980s, when trust fund insolvency and federal borrowing by states led to declines in access to benefits.

Mr. Chairman and Members of the Subcommittee:

I am pleased to be here today to testify before this subcommittee on our work concerning the Unemployment Insurance (UI) system. My purpose today is to provide information that GAO developed on issues of interest to your subcommittee regarding administrative financing. In addition, as you requested, I will provide an update on the adequacy of trust fund reserves, an issue on which we testified before the subcommittee in December 1987.

Language in Conference Report 99-960 requested GAO to monitor the operation of state UI agencies and report on the effects of reductions in federal administrative funding. That report to the Senate and House Appropriations committees is being issued today (GAO/HRD-89-72BR). My testimony on administrative financing is based on this report.

Our work shows that the federal allocations to the states for UI administration are less than what is required for the effective and efficient operation of many states' UI programs.

Specifically:

o The federal budgetary and appropriations process has historically authorized less administrative funding than Labor estimates is needed by states to process their UI workloads.

o States are increasingly using their own funds to supplement federal funds for the administration of their UI program and are making managerial changes in an attempt to increase program efficiency. State officials claim these actions are needed to offset federal underfunding.

o The Department of Labor's allocation system--a complex workload-driven funding allocation mechanism--uses outdated information that no longer provides accurate estimates of various components of state costs.

o States have maintained a generally stable structure of 1,850 claims offices, but have reduced staffing.

Our work indicates that serious disruptions in service and increases in claims processing errors will likely occur if unemployment rates rise suddenly because many states would be unable to get adequately trained staff processing claims as quickly as possible. This is because the states, for a variety of reasons have reduced the pool of part-time/temporary workers who have traditionally been called on to process claims when workloads increase suddenly during recessions.

Because you also expressed an interest in the issue of the solvency of state benefit trust funds, we have updated information we reported last September (GAO/HRD-88-55) and in testimony before this committee in December 1987 regarding the limited number of states with adequate reserves. Despite another year of economic expansion and low unemployment, the reserve adequacy picture remains about the same--namely, trust fund reserves have shown only limited improvement and most states have not accumulated reserves sufficient to withstand a serious recession.

Before elaborating on these points, I would like to describe our methodology and provide some background on how the UI system finances state administrative costs.

METHODOLOGY

To develop the information, we created a data base that included spending, staffing, and workload information on the 53 jurisdictions currently operating UI programs. Specifically, using a questionnaire sent to these jurisdictions, we developed an 8-year profile of federal and state funding, spending, and staffing, and state office openings and closings. We obtained budget and workload data from the Department of Labor and met with Labor's program officials in Washington D.C. and three of its regional offices. We also interviewed state and local UI officials in six judgmentally selected states--California, Georgia, Kentucky, Louisiana, New York, and Ohio.

BACKGROUND

The UI system is the federal government's major means of providing income maintenance assistance to the unemployed 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 1988, the trust funds of the 50 states, the District of Columbia, Puerto Rico, and the Virgin Islands paid about $13.3 billion in regular state benefits to about 7 million unemployed workers and collected about $18 billion in employer taxes. 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.

State administration is funded by an employer-paid federal tax on payrolls called the FUTA (Federal Unemployment Tax Act) tax. A portion of the FUTA tax is earmarked for state administration of the UI programs. Labor allocates funds from this account to the states through a process originally designed to provide full funding necessary for effective and efficient program operation. During the 1980s Labor has taken actions to give states greater managerial flexibility and authority over their federal allocations. For example, in 1986, Labor gave states the authority to shift funds among program accounts without the federal approval previously required.

Labor's System for Estimating State UI Administrative Funding Needs

Labor's funding allocation system develops separate estimates for each state's personnel services (PS) costs--which include employee wages and benefits--and nonpersonal services (NPS) costs --which include rent, maintenance, supplies, communications, travel, equipment, and other purchases (see fig. 1).

Figure 1

GAO UI Administrative Funding Categories

- Personnel Services (PS)
  Based on state:
  - Workload
  - Processing times
  - Salary and benefit costs

- Nonpersonal Services (NPS)
  Based on:
  - 1983 NPS staff year cost
  - Adjusted annually for inflation

Using what Labor calls the "cost model," personnel services funding is determined by computing an estimate of each state's workload, multiplied by a minutes-per-unit time factor for each kind of work performed--such as processing initial claims, continuing claims, or appeals. The resulting number of minutes are converted into full-time equivalent staff-years which, when multiplied by each state's average annual staff-year cost for UI salary and benefits, determines the state's estimated "PS" costs.

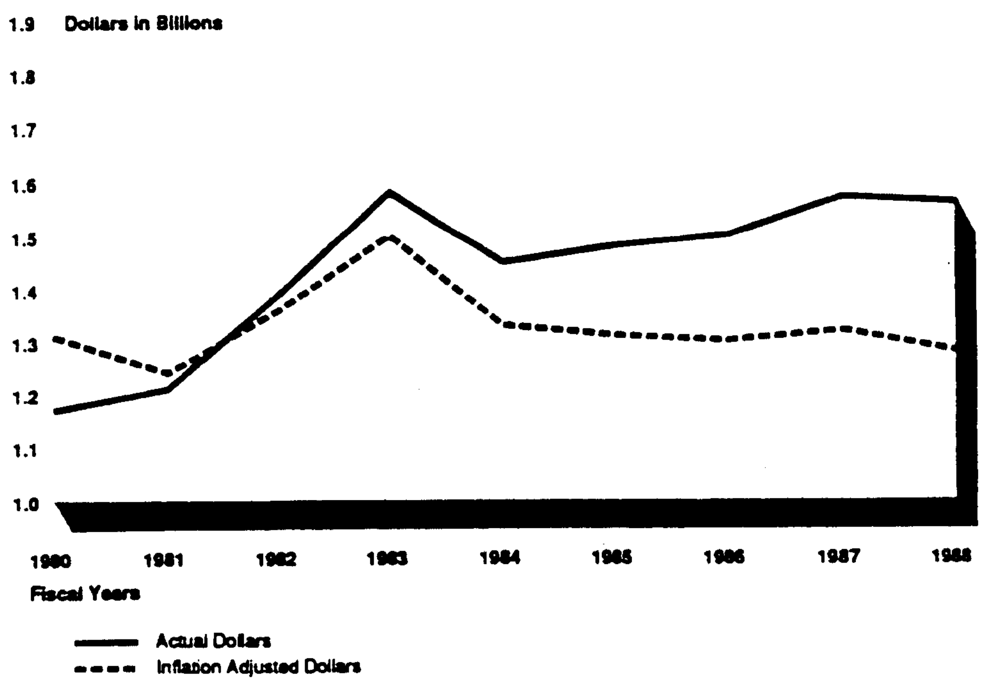
"NPS" costs are computed by again using each state's estimated full time equivalent staff-year needs and a state specific cost per staff-year factor. This factor is derived from actual 1983 NPS spending adjusted each year for inflation.

1980 TRENDS IN STATE UI ADMINISTRATIVE FUNDING

Federal funding for UI administration has risen and fallen during the 1980s following the pattern of UI workload that accompanies periods of recession and economic recovery. Federal funding increased substantially during the early 1980s, peaking at about $1.6 billion in 1983, when the nation's annual civilian unemployment rate was 9.6 percent (see fig. 2). Funding for fiscal year 1984 dropped by 8 percent when UI workloads declined sharply. For example, "weeks claimed", one of four major components of workload decreased by 40 percent between 1983 and 1984. Since 1984, UI funding has increased slightly, although when adjusted for inflation, funding has been nearly constant, and in fact, has declined slightly.

Figure 2

GAO Federal Funding for State UI Administration

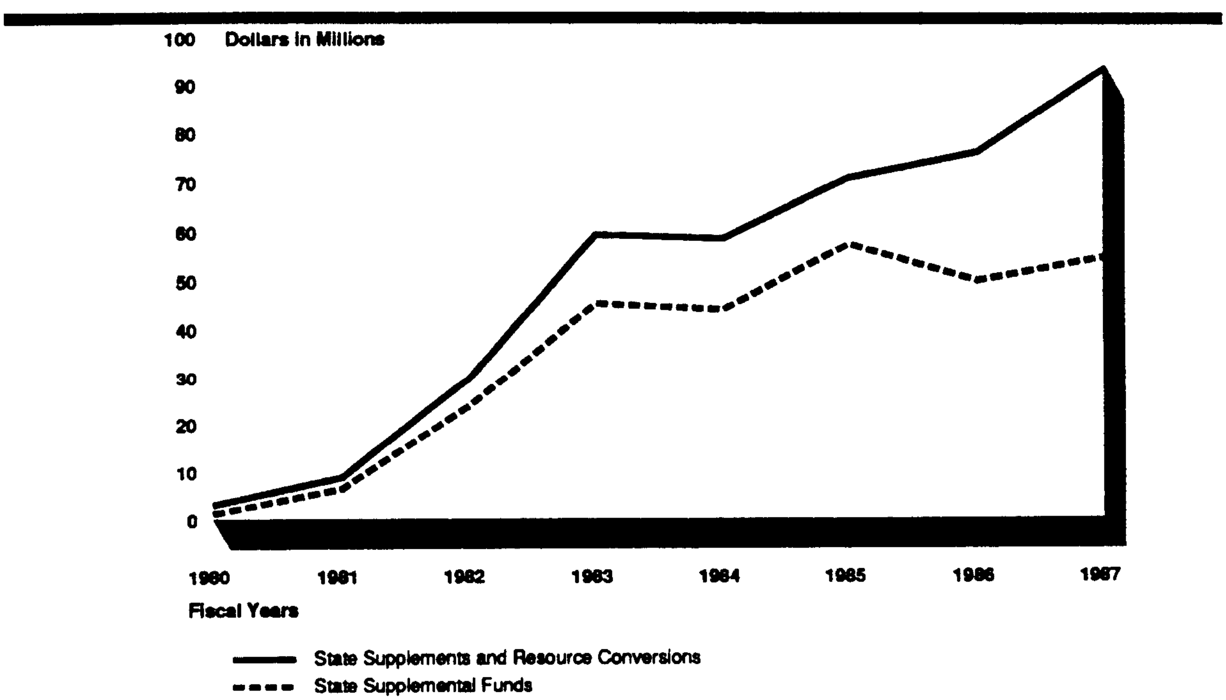


Inflation adjustment is with the Gross National Product Deflator (1982=100).

Although funding trends have generally followed workload trends, throughout the 1980s, federal UI administrative funding has been less than that considered adequate by the states. According to Labor officials, since at least the late 1970s, federal allocations have been less than Labor's estimates of states' funding needs. State officials maintain, however, that the problem has become more serious in the 1980s and cuts in requested budget levels have exceeded the reductions justified by workload declines. In addition to workload, decisions made in the budget and appropriations process have further affected total federal funding for states' UI administrative expenses. The Office of Management and Budget (OMB) has at times reduced Labor's funding requests for UI administration. The Gramm-Rudman-Hollings legislation has also had an effect, resulting in cuts in fiscal year 1986 funding. In addition, the Congress reduced Labor's requested budget for UI administrative funding for fiscal year 1987 by $144 million, a 9-percent cut of Labor's budget request.

Figure 3

GAO State Financial Adjustments



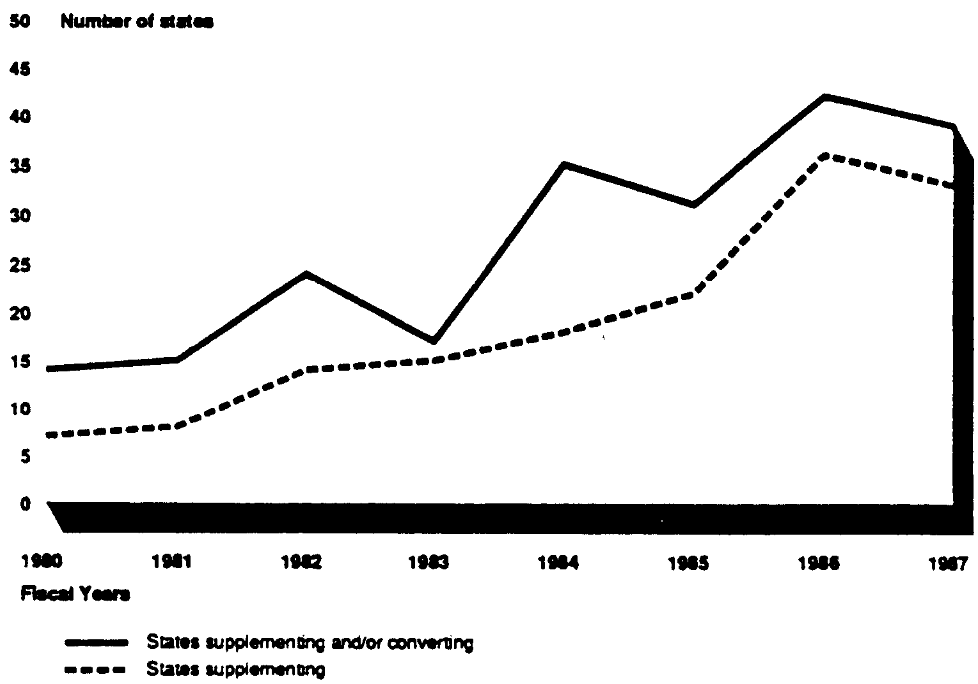
Resource conversions are personnel services into nonpersonal services.

STATE FINANCIAL AND MANAGERIAL ADJUSTMENT TO FUNDING CHANGES

States have had to make financial adjustments during the 1980s because the UI system is underfunded and for many states, federal allocations do not cover the actual costs of program administration, especially nonpersonal services costs. Since 1980, a growing number of states have supplemented their federal allocations with increasing amounts of their own funds. In 1980, 8 states provided a total of $1.1 million in supplements to their UI system (an average of $138,000 each) (see fig. 3 and fig. 4).

Figure 4

GAO States Supplementing and Converting Federal Allocations



By 1987, the number had increased to 33 states providing $54.1 million in supplemental funding (an average of $1.6 million), about 4.4 percent of their total spending. The predominant source of state funds is their Penalty and Interest accounts--state funds that accumulate from charges assessed on employers for delinquent or late UI tax payments--which accounted for between 55 and 77 percent of all state supplemental funding in fiscal years 1985 through 1987.

Another financial adjustment states have made was to convert funds allocated for personnel services costs to cover nonpersonal services expenses. The dollar value of such conversions has risen by 20 times since 1980, from 7 states shifting $1.9 million in 1980 (an average of $270,000 each) to 21 states converting $38.5 million in 1987 (an average of $1.8 million).

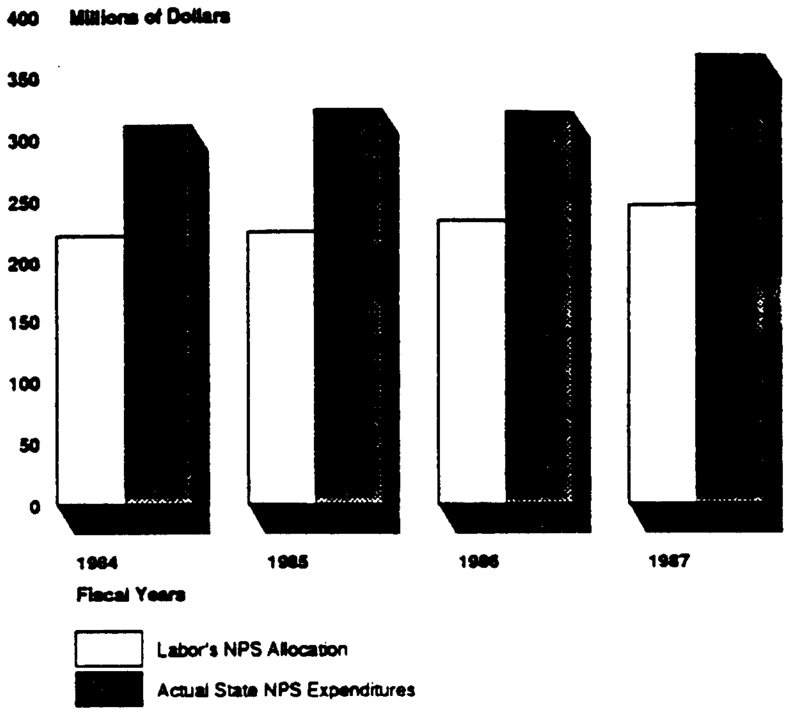
The Department of Labor's cost estimation procedures no longer provide accurate estimates of the various components of state administrative costs, especially NPS costs, because certain basic data needed to estimate state costs are no longer collected. For example, processing time data have not been updated since 1986, and actual NPS expenditure data were last collected in 1983.

An example of the kind of impact that the use of this dated information has on Labor's cost estimates is provided by examining NPS allocations and costs. While Labor's cost estimation methodology implies that individual state NPS expenditures are a fixed proportion of total costs, our information shows that spending on goods and services as a percentage of total program expenditures has risen during the 1980s, from 20 percent in 1980 to 23 percent in 1987. In addition, as NPS expenditures have increased, the proportion of state NPS costs allocated by Labor has declined, resulting in a substantial "gap" between the amount Labor provides for NPS funding and actual state spending. State spending on goods and services has been from 38 to 50 percent more than Labor's allocations in fiscal years 1984 through 1987 (see fig. 5).

State officials in four states that used supplemental funds said that such funds were generally required to finance NPS costs to maintain basic program activities. The view that Labor underestimates NPS costs was widespread. Officials in all six states we visited believed that NPS funding was inadequate for their program needs. Regional Labor officials in Region IV (Atlanta), covering eight states, and Region IX (San Francisco), with four states, echoed this view.

Figure 5

GAO **NPS Allocations and Actual State NPS Spending**



In addition, state UI officials believe that federal budgetary reductions have led to managerial changes that have increased program efficiency but have also raised staff training requirements. To improve efficiency, many states have:

-- increased the use of automation,
-- permitted more claimants to file by mail to reduce office traffic, and
-- located more UI offices together with Employment Service (ES) offices, to allow staff to be used for either program.

Added Complexity and Training

In the six states we visited, officials reported that automation has tended to increase efficiency, but has also made claims processing more complex and increased the desirable level of training for staff. The increased use of staff to perform both ES and UI program functions has also increased the need for training. Yet, despite increased training needs, 11 states reported that tight budgets have forced a decline in spending for training.

As of 1987, states reported an average training period including both formal and on-the-job training for a typical UI function, such as taking initial claims, to be about 120 days. Training periods of 180 days or more were reported by 15 states. Although statistics were unavailable for earlier years, officials in four of the states that we visited told us that the length of time needed to become proficient at numerous program functions had increased significantly since the early 1980s. Labor regional officials in San Francisco and Atlanta also believed that staff training requirements had increased for many of the states in their jurisdictions.

NUMBER OF OFFICES STABLE

In the aggregate, the number of permanent UI claims offices, the basic unit of service provision, changed little, remaining at about 1,850 during the 1980s. Office openings and closings have not mirrored the cyclical workload changes, however, and have been unevenly distributed across the country.

Most of the closings occurred before 1984, when workload was high. More than 50 percent of the 233 office closings occurred in seven states, with Colorado, Michigan, New York, and Ohio each closing 20 or more offices.

Most openings occurred after 1984, when workload was declining. Three states--Georgia, Iowa, and Tennessee--accounted for over 50 percent of the 164 office openings, reporting that UI offices were opened to locate them jointly with ES offices.

Officials from four of the six states we visited reported that the decisions to close permanent UI offices were often controversial. The belief that service quality would decline due to reduced access to claims offices often generated considerable local opposition. On the other hand, UI officials in two states said they were reluctant to open new offices because of the expense involved and the difficulty to be encountered if a subsequent closing became necessary.

The number of satellite or temporary offices offering less than 5-day service declined almost continuously in the 1980s from 823 in 1980 to 604 in 1987--a reduction of 27 percent. This may be explained by the fact that, as one state official told us, it is easier to close satellite offices because there is less local opposition.

STAFF LEVELS DECLINE

Unlike office closings and openings, aggregate staffing levels have generally fluctuated in concert with workload changes. Staff years used, as measured by full-time equivalents, declined by about 27 percent since 1983 to about 40,000 staff years in 1987. This decline has occurred principally at claims offices, where staffing dropped from an average of 14 staff years per office in 1983 to an average of 8 in 1987.

The decline in aggregate UI workload and staff-years during the 1980s has reduced the use of "intermittent" (part-time or temporary) employees in many states. These workers give many states the flexibility to handle changes in workload. State officials in five of the six states we visited reported a substantial attrition of part-time and temporary UI employees in recent years. State officials mentioned a variety of factors causing this decline. Reasons cited include workload-driven funding declines; automation, which has made states more efficient; collective bargaining agreements, which favor more senior and permanent employees; and worker desires for full-time work. This trend may be problematic because the system has traditionally relied on part-time workers to handle sudden workload increases because they can readily increase their hours. This development was corroborated by Labor regional officials in Atlanta and San Francisco.

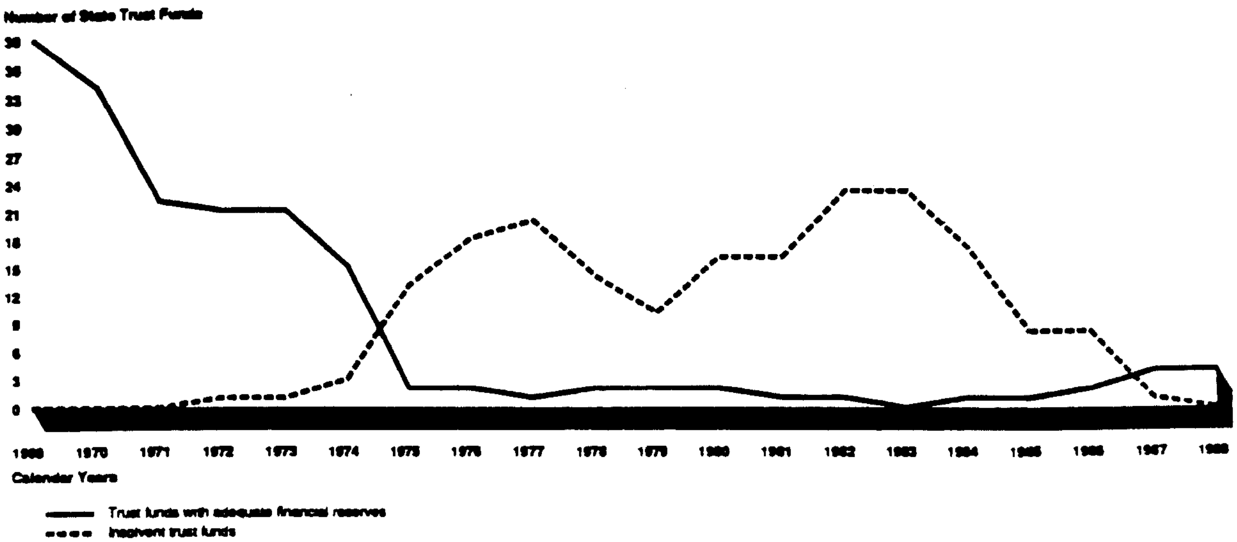
TRUST FUND SOLVENCY PROBLEMS

In GAO's September 1988 report, we noted that despite the sustained economic expansion, many states still had not accumulated trust fund reserves sufficient to withstand another serious recession without substantial new federal borrowing. Looking at more recent data on solvency, as of December 1988, our conclusion is unchanged--despite continued prosperity, the trust fund reserves of most states are still inadequate and have shown limited improvement in the last year (see fig. 6).

Aggregate reserves have continued to increase. At the end of 1988, the system's net reserves had reached a new historic high of $31.3 billion, up from $23.2 billion at the end of 1987. However, potential program liabilities have also increased and thus, the ratio of reserves to recession-level benefits, as measured by the "High Cost Multiple," has shown only limited improvement. The High Cost Multiple provides an indication of how long recession-level benefits could be paid from current reserve balances. At one time, the Department of Labor recommended that states maintain reserves equal to a multiple of at least 1.5 or reserves sufficient to pay recession-level benefits for 1-1/2 years. However, despite continued economic expansion, the system's multiple has increased slowly, standing

Figure 6

GAO Adequacy and Solvency of State UI Trust Funds



at 0.78 as of December 1988--meaning that reserves on average were sufficient to pay recession level benefits for less than 10 months.

Looking at individual programs, reserve adequacy is even more limited. At the end of 1988, four trust funds--Mississippi, Puerto Rico, South Dakota, and the Virgin Islands--met the 1.5 high cost multiple standard, the same as in 1987 and up from two in 1986. By comparison, 39 programs had adequate trust fund reserves in 1969.

As noted in our 1988 report, reserve accumulation has been slowed by reductions in state UI taxes and by restructuring of some state UI tax systems specifically to limit reserve levels. As a consequence, many states are simply not accumulating reserves sufficient to withstand a recession without substantial new borrowing from the federal government.

Because the insolvency experienced in the early 1980s contributed somewhat to the long term downward trend in the percentage of the unemployed receiving benefits, in prior testimony we suggested that actions be taken to avoid a similar occurrence in the future. For example, to minimize the potential for significant state borrowing in future recessions, a reserve requirement or some other mechanism would be necessary. The requirement could incorporate a state's current and historical economic conditions, include a grace period for compliance based on variations in present state economic health, and be buttressed by financial incentives. We also suggested that the Congress consider increasing somewhat the federal unemployment insurance tax with the additional proceeds being used to aid those states with particularly severe unemployment conditions. Finally, because current policy has had the effect of encouraging an erosion of benefits to many workers, we suggested that the Congress may wish to craft any measure to improve reserve adequacy in a way that does not further erode benefit eligibility.

CONCLUSION

Although the FUTA tax was envisioned as the sole source of funding to cover the costs of administering the UI program, during the 1980s this premise appears to have been eroded. Federal spending for state UI administration has been consistently less than Labor's estimate. States have increasingly used their own funds and made other managerial changes to help cover the costs of UI administration. However, should workload suddenly rise, disruptions in service or increases in claims processing errors could occur because states would be unable to get adequately trained staff processing claims as quickly as necessary (see fig. 7). Because of workload declines and other factors, state programs have lost substantial numbers of part-time/temporary workers who are relied on to handle sudden rises in workload. Increased training needs for new staff could further hamper service delivery.

Figure 7

GAO The Funding Situation and Its Implications

- Federal funding increasingly insufficient

- States have cut costs, and added their own funds

- Recession likely to cause problems
  - Claims processing errors
  - Promptness
  - Service disruptions

In addition, during the next recession, inadequate state benefit trust fund reserves could threaten a repeat of the experience of the early 1980s, with trust fund insolvency and federal borrowing leading to limitations in the access to benefits and increases in employer taxes.

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Mr. Chairman, that concludes my prepared statement. My colleagues and I will be happy to answer any questions you or other members of the subcommittee may have.