

BACKGROUND PAPER

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Unemployment Insurance Taxes: Options for Program Design and Insolvent Trust Funds

Businesses Face Higher Taxes as States Exhaust Trust Funds and Incur Interest Payments

By
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Key Findings

- *Unemployment insurance (UI) is a social insurance program jointly operated by the federal and state government. Employers pay federal and state UI taxes that fund benefits, with employers paying different tax rates based on their layoff history (“experience rating”).*
- *High rates of unemployment and benefits lasting up to 99 weeks have led 34 states to borrow over \$37 billion from the federal government to pay benefits. States are not expected to repay these amounts for some time and must begin paying interest on their balances in 2011.*
- *Businesses are in danger of facing higher UI taxes at a time when private sector hiring is already at a low level. Some states are already reducing UI benefits or raising taxes.*
- *States routinely cut UI taxes in good economic times and raise them in bad economic times, undermining the argument that the program is countercyclical.*
- *Modest UI reforms should be considered, including eliminating the “firewall” between administrative costs and benefits, reducing cross-subsidies to high-layoff employers, and relying more on face-to-face training and advising. More significant reforms that could be considered include adopting elements of state workers’ compensation programs and experimenting with individual accounts.*
- *Economic evidence suggests that extending unemployment benefits increases unemployment by encouraging “excessive search.”*
- *States should be sure that their UI tax systems are not overly complex and burdensome, particularly to new employers. States should also balance the goal of spreading the costs of unemployment to all employers with the danger of overly subsidizing high-turnover employers. Finally, states should resist efforts to introduce need-based features into UI.*

Joseph Henchman is the Vice President of Legal & State Projects at the Tax Foundation. He would like to thank Dr. William Conerly for his prior work on the subject and his advice, as well as Elsie Watters, the author of our 1981 study on unemployment insurance. He would also like to acknowledge the valuable research assistance of Sarah Hyon and Frederick Hubach.

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Introduction

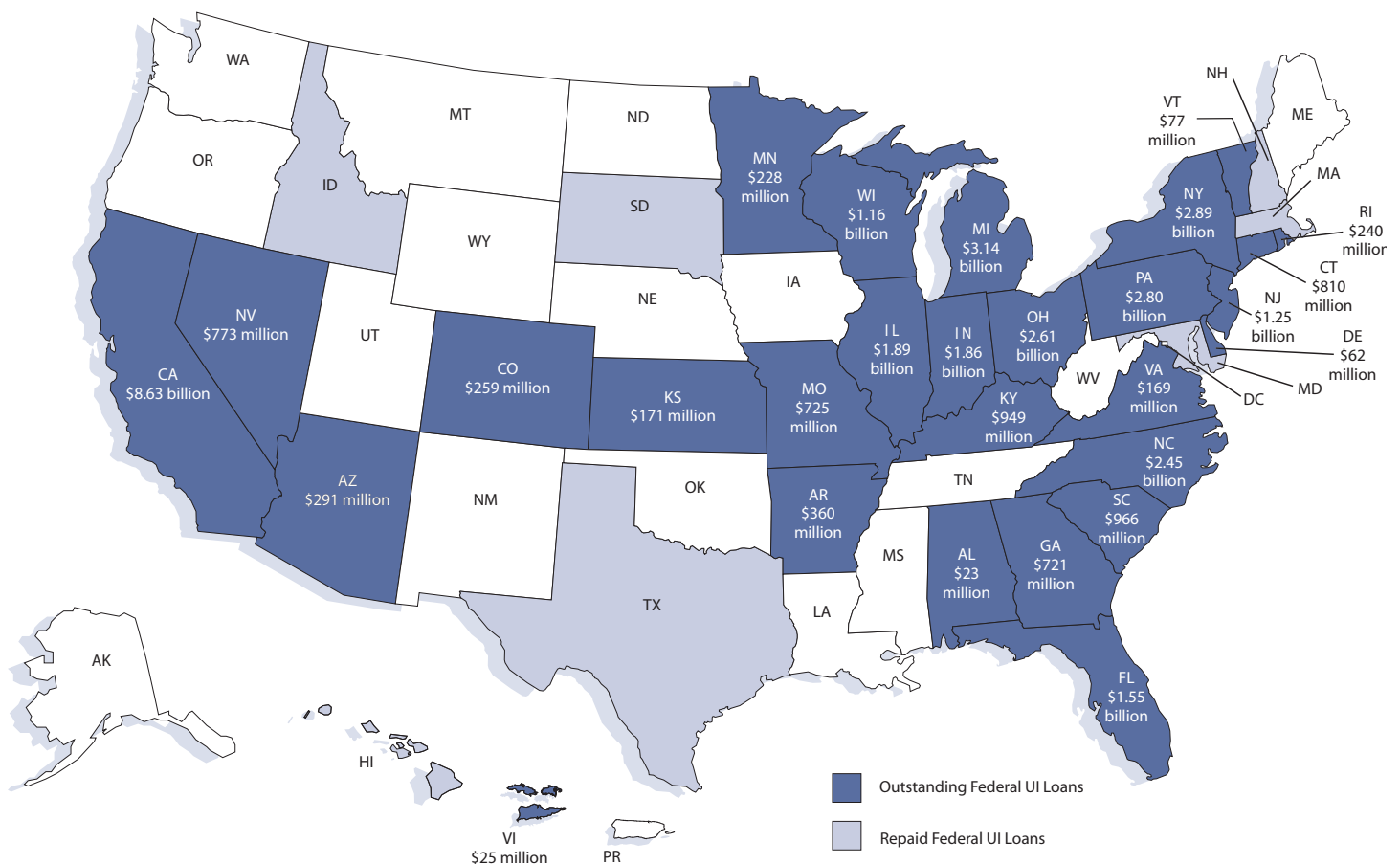
Record high levels of unemployment and record low reserve funds have placed great pressure on the federal-state unemployment insurance (UI) tax and benefit system. Between 2008 and 2011, \$174 billion was paid in unemployment taxes while \$450 billion was paid out in benefits, a gap of \$276 billion.¹ In 2011 alone, employers and employees are projected to pay \$51.8 billion in taxes, while \$131.4 billion is projected to be paid out in benefits for workers recently unemployed.² Benefits are drawn for an average of 18 weeks, with many claimants receiving the maximum 99 weeks of benefits.

Over the past two years, 34 states and the U.S. Virgin Islands exhausted their unemployment insurance trust funds and have had to borrow from the federal government to pay unemployment benefits; 27 states have outstanding balances

(see Figure 1). While 4 million new hires are made each month, the unemployment rate has stood above 9 percent and the number of unemployed per job opening remains high (see Figures 2 and 3). While some states have repaid their balances and others are no longer borrowing additional amounts, the current outstanding balance of loans is \$37.3 billion. States are not expected to repay their loans fully for several years.

Beginning on September 30, 2011, states must pay approximately \$1.3 billion in interest on those outstanding balances; in many cases, businesses and employees in those states will also face increases in federal unemployment insurance tax rates as a result of those federal loan balances. These new interest obligations and tax increases, if they ultimately occur, come at a time when private sector hiring is already at a low level and states are under significant fiscal pressure. These unemployment insurance fiscal policies may exacerbate

Figure 1
Federal Loans to States to Pay Unemployment Benefits



Source: US Department of Labor Employment & Training Administration, as of September 2011

1 Office of Management and Budget, Budget of the U.S. Government Fiscal Year 2012: Historical Tables (Feb. 14, 2011), <http://www.gpoaccess.gov/usbudget/fy12/pdf/BUDGET-2012-TAB.pdf>.

2 *Id.*

negative job growth and tax trends, instead of operating countercyclically as the program was intended.

Consequently, this may be an appropriate time for the federal government and the states to contemplate significant changes to the structure of unemployment insurance taxation and benefits. Program design alternatives could offer more innovative and more sustainable methods to find jobs for the short-term and long-term unemployed while preserving benefits to support them in the meantime. These options include eliminating the firewall between administrative costs and benefits, reducing cross-subsidies through greater use of experience ratings, relying more on face-to-face training and advising, adopting elements of state workers' compensation programs, and experimenting with individual accounts to encourage saving. These changes can enhance the program's ultimate goal of ensuring a viable safety net for transition periods between employment.

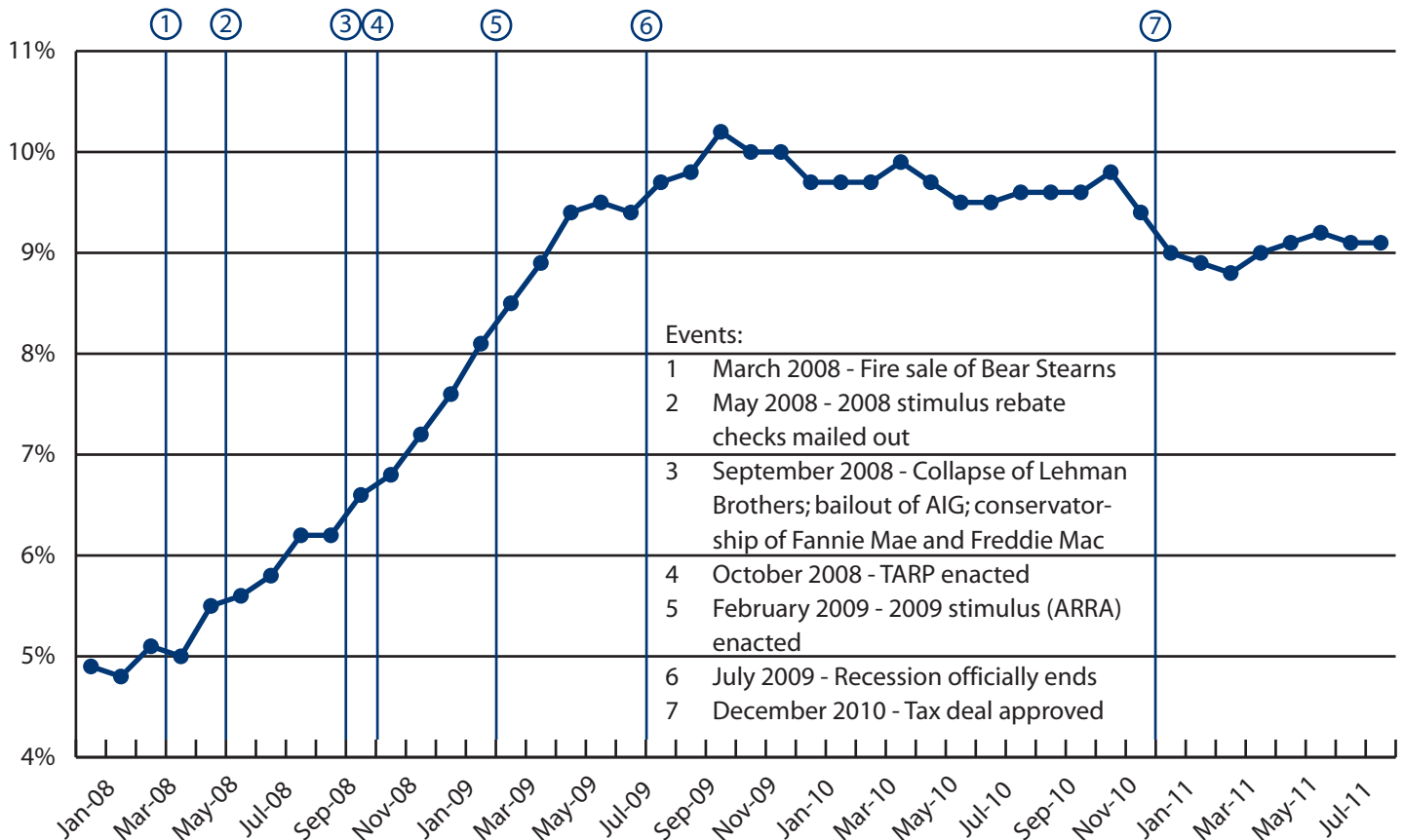
How the Unemployment Insurance System Works

Unemployment insurance is a social insurance program jointly operated by the federal and state governments.³ Employers and employees pay taxes to the federal and state governments, while state governments administer the program and the federal government reimburses the states for administrative expenses. In times of high unemployment, benefits are extended in time and states unable to pay benefits out of accumulated trust fund reserves may borrow from the federal government for that purpose.

History and Goals of Unemployment Insurance

Enacted in 1935 as part of the Social Security Act, the federal unemployment insurance program was modeled after similar programs implemented in

Figure 2
U.S. Unemployment Rate and Key Events Since 2008



Source: U.S. Department of Labor.

³ In addition to the 50 states, other participants in the program include the District of Columbia, Puerto Rico, and the U.S. Virgin Islands.

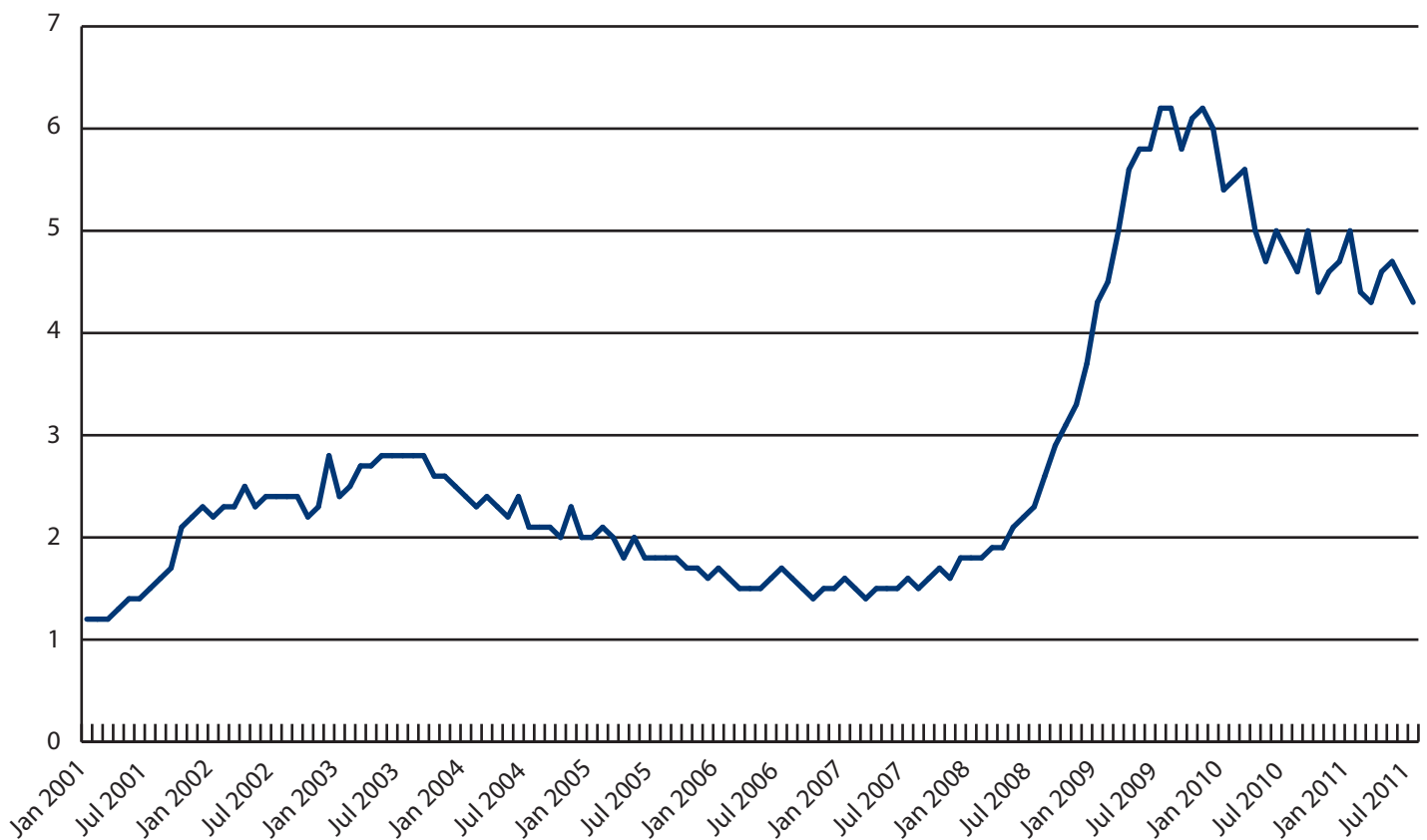
Britain (adopted 1911, expanded to entire workforce in 1920), Italy (1919), Germany (1927), and 18 other countries.⁴ Unemployment insurance itself dates to a city plan in Switzerland in 1789 and union-administered and company-administered plans going back as far as 1831, although they covered only a small number of workers.⁵ The first bill to create a state-level compulsory unemployment insurance program was introduced in Massachusetts in 1916, and a number of states considered such laws in subsequent years but none passed.⁶

At the time, unemployment was viewed as a problem to be addressed by the workers themselves, their unions, and perhaps the states; at most, the federal government would hold a

hearing or a conference but further action was considered undesirable and even unconstitutional.⁷ Ideas for combatting unemployment included providing free transportation to the West for the unemployed (1870s Greenback Party platform), immigration restrictions, public works jobs, currency and tariff reform, shorter work days, and better education. “In general, the emphasis lay on prevention of unemployment more than on amelioration of the problems of the worker without a job.”⁸

Modern observers may be surprised that organized labor was a key opponent of compulsory state unemployment insurance. Samuel Gompers, the long-time head of the American Federation of Labor, argued that compulsory unemployment in-

Figure 3
Unemployed Persons per Job Opening



Source: Bureau of Labor Statistics, Job Openings and Labor Turnover Survey (JOLTS).

4 See Chris Edwards & George Leef, *Failures of the Unemployment Insurance System*, Cato Institute (2011), <http://www.downsizinggovernment.org/labor/failures-of-unemployment-insurance>; Elsie M. Watters, *Unemployment Insurance: Trends and Issues*, Tax Foundation Research Publication No. 35 (1982), <http://www.taxfoundation.org/news/show/2022.html>.

5 See U.S. Social Security Board, *Unemployment Compensation: What and Why?* (1937). At least one scholar posits that states prohibited the creation of extensive private unemployment insurance schemes by insurance companies so as to protect union-administered plans from competition. See Michael B. Rappaport, *The Private Provision of Unemployment Insurance*, 1992 Wisconsin L. Rev. 61 (Jan.-Feb. 1992).

6 See U.S. Social Security Board, *supra* note 5.

7 See Watters, *supra* note 4, at at 3-4 (citing the Wagner Committee report that preferred federal tax credits to businesses that purchase private unemployment insurance and rejected a federal system, and a 1921 conference on unemployment presided over by then-Secretary of Commerce Herbert Hoover.)

8 *Id.* at 2.

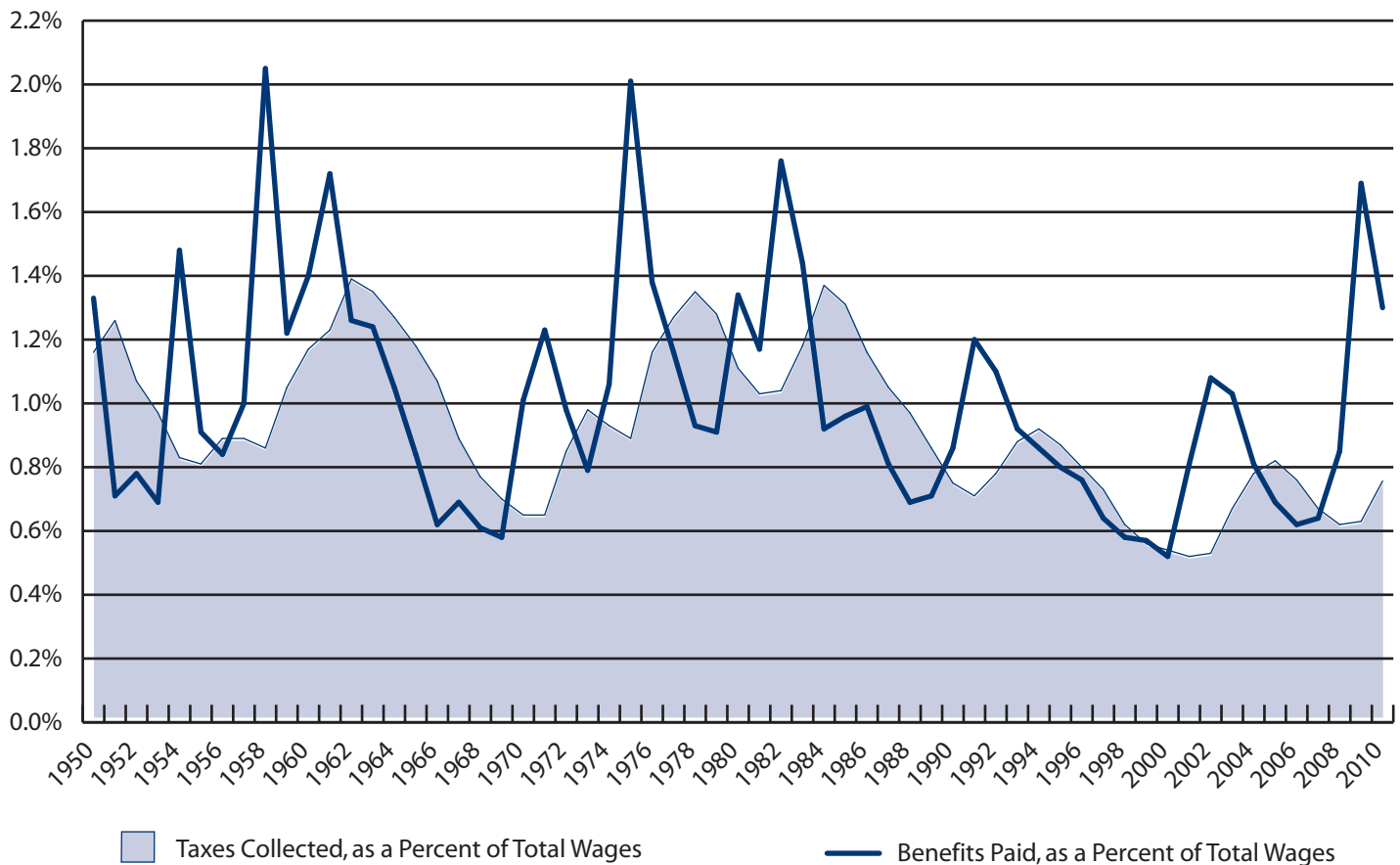
insurance would substitute government dependency for benefits administered by unions themselves, and was pushed by supporters “who know nothing of the hopes and aspirations of labor which desires opportunities for work, not for compulsory unemployment insurance.”⁹ A government program, aside from public works jobs, “was regarded as interference and a threat to union independence.”¹⁰

The Great Depression of the 1930s, with unemployment levels reaching 25 percent, changed these public attitudes. Wisconsin was the first state to adopt a compulsory program, in 1932.¹¹ Although a number of states expressed interest in adopting a state-level program, no others did so; one state reported that the competitive advantage of its employers and employees not having to pay taxes for a program outweighed the program’s benefits.¹² Proponents argued that compulsory unemployment insurance could provide a financial safety net to discharged employees, might discour-

age employers from adding to unemployment by increasing their costs for doing so, and counter economic cycles by encouraging saving in good times and paying out benefits in times of slow aggregate demand. After vetoing legislation that would have authorized private insurance companies to offer unemployment insurance, then-New York Governor Franklin Roosevelt assembled a six-state commission to develop recommendations for unemployment insurance programs.

This commission recommended a federal-state cooperative system that would allow a nationwide pooling of risk, prevent interstate competition by requiring all states to participate, and leave administration and benefit design to the states (“uniformity where essential and diversity where desired”).¹³ The states were left free to determine the taxable wage base (so long as it was at or above the federal minimum), experience-rating methods, tax rates, eligibility and

Figure 4
Unemployment Taxes and Benefits as a Percent of Wages over Time



9 *Id.* at 2-3; Aaron Steelman, *If Only Samuel Gompers Were Alive Today*, Cato Institute (Oct. 1996), http://www.cato.org/pub_display.php?pub_id=6274; Samuel Gompers, *American Federationist: Promises and Performances* at 680-81 (Jul. 1916).

10 Watters, *supra* note 4, at 3.

11 See *id.*

12 See Report of the Ohio Commission on Unemployment Insurance (1932).

13 See U.S. Social Security Board, *supra* note 5.

disqualification rules, and benefit amounts and duration.¹⁴ Additionally, the program would not be need-based, providing “no more than a subsistence income” as “a uniform percentage of former full-time wages,” and be funded entirely by taxes on employers and employees.¹⁵ These goals informed the federal legislation (the Federal Unemployment Tax Act, or FUTA) that was attached to the Social Security Act and signed into law by President Roosevelt in 1935.

Modern observers may be surprised that organized labor was a key opponent of compulsory state unemployment insurance. Samuel Gompers ... argued that compulsory unemployment insurance would substitute government dependency for benefits administered by unions themselves.

Federal Unemployment Insurance Tax and Employer Credits

A federal tax of 6.0 percent is ostensibly levied on the first \$7,000 of each worker’s earnings to finance the UI program.¹⁶ However, if a state has adopted a UI program that meets federal guidelines, employers in the state can credit state UI taxes against up to 90 percent of their federal UI tax, on a dollar-for-dollar basis. Thus, when a state UI program meets all federal requirements, employers in the state pay a federal tax rate of 0.6 percent plus state UI taxes.¹⁷ The tax-and-credit-offset feature of the program, designed by then-Supreme Court Justice Louis Brandeis, was designed to avoid constitutional concerns and ensure that all states set up UI programs after the federal law was enacted.¹⁸

Revenue from the federal tax is used to pay federal and state administrative costs of the UI program,

Table 1
Minimum Rates, Maximum Rates, New Employer Rates, Taxable Wage Base by State

State	Minimum Tax Rate	Maximum Tax Rate	New Employer Rate	Taxable Wage Base
Alabama	0.6%	6.7%	2.7%	\$8,000
Alaska	1.0%	5.4%	3.4%	\$34,600
Arizona	0.0%	5.9%	2.0%	\$7,000
Arkansas	1.0%	6.9%	3.8%	\$12,000
California	1.5%	6.2%	3.4%	\$7,000
Colorado	1.0%	5.4%	1.7%	\$10,000
Connecticut	1.9%	6.8%	3.7%	\$15,000
Delaware	0.1%	8.0%	2.6%	\$10,500
Florida	1.0%	5.4%	2.7%	\$7,000
Georgia	0.0%	5.4%	2.6%	\$8,500
Hawaii	1.2%	5.4%	4.0%	\$34,200
Idaho	1.0%	6.8%	3.4%	\$33,300
Illinois	0.7%	8.4%	3.8%	\$12,740
Indiana	0.7%	9.5%	2.5%	\$9,500
Iowa	0.0%	9.0%	1.9%	\$24,700
Kansas	0.1%	7.4%	4.0%	\$8,000
Kentucky	1.0%	10.0%	2.7%	\$8,000
Louisiana	0.1%	6.2%	Industry Average	\$7,700
Maine	0.9%	8.0%	3.0%	\$12,000
Maryland	2.2%	13.5%	2.6%	\$8,500
Massachusetts	1.3%	12.3%	2.8%	\$14,000
Michigan	0.1%	10.3%	2.7%	\$9,000
Minnesota	0.5%	9.4%	2.9%	\$27,000
Mississippi	0.9%	5.4%	2.7%	\$14,000
Missouri	0.0%	9.8%	3.5%	\$13,000
Montana	0.8%	6.1%	Industry Average	\$26,300
Nebraska	0.0%	8.7%	2.5%	\$9,000
Nevada	0.3%	5.4%	3.0%	\$26,600
New Hampshire	0.0%	7.0%	3.7%	\$12,000
New Jersey	0.5%	5.8%	2.8%	\$29,600
New Mexico	0.1%	5.4%	2.0%	\$21,900
New York	1.5%	9.9%	4.1%	\$8,500
North Carolina	0.2%	6.8%	1.2%	\$19,700
North Dakota	0.2%	10.0%	1.4%	\$25,500
Ohio	0.7%	9.6%	2.7%	\$9,000
Oklahoma	0.3%	7.5%	1.0%	\$18,600
Oregon	2.2%	5.4%	3.3%	\$32,300
Pennsylvania	2.7%	10.8%	3.7%	\$8,000
Rhode Island	1.7%	9.8%	2.5%	\$19,000
South Carolina	0.1%	11.3%	2.9%	\$10,000
South Dakota	0.0%	9.5%	1.2%	\$11,000
Tennessee	0.5%	10.0%	2.7%	\$9,000
Texas	0.8%	8.3%	2.7%	\$9,000
Utah	0.4%	9.4%	Industry Average	\$28,600
Vermont	1.3%	8.4%	1.0%	\$13,000
Virginia	0.8%	6.9%	3.2%	\$8,000
Washington	0.5%	6.0%	Industry Average	\$37,300
West Virginia	1.5%	7.5%	2.7%	\$12,000
Wisconsin	0.3%	9.8%	3.6%	\$13,000
Wyoming	0.7%	10.0%	Industry Average	\$22,300
District of Columbia	1.6%	7.0%	2.7%	\$9,000

Source: U.S. Department of Labor

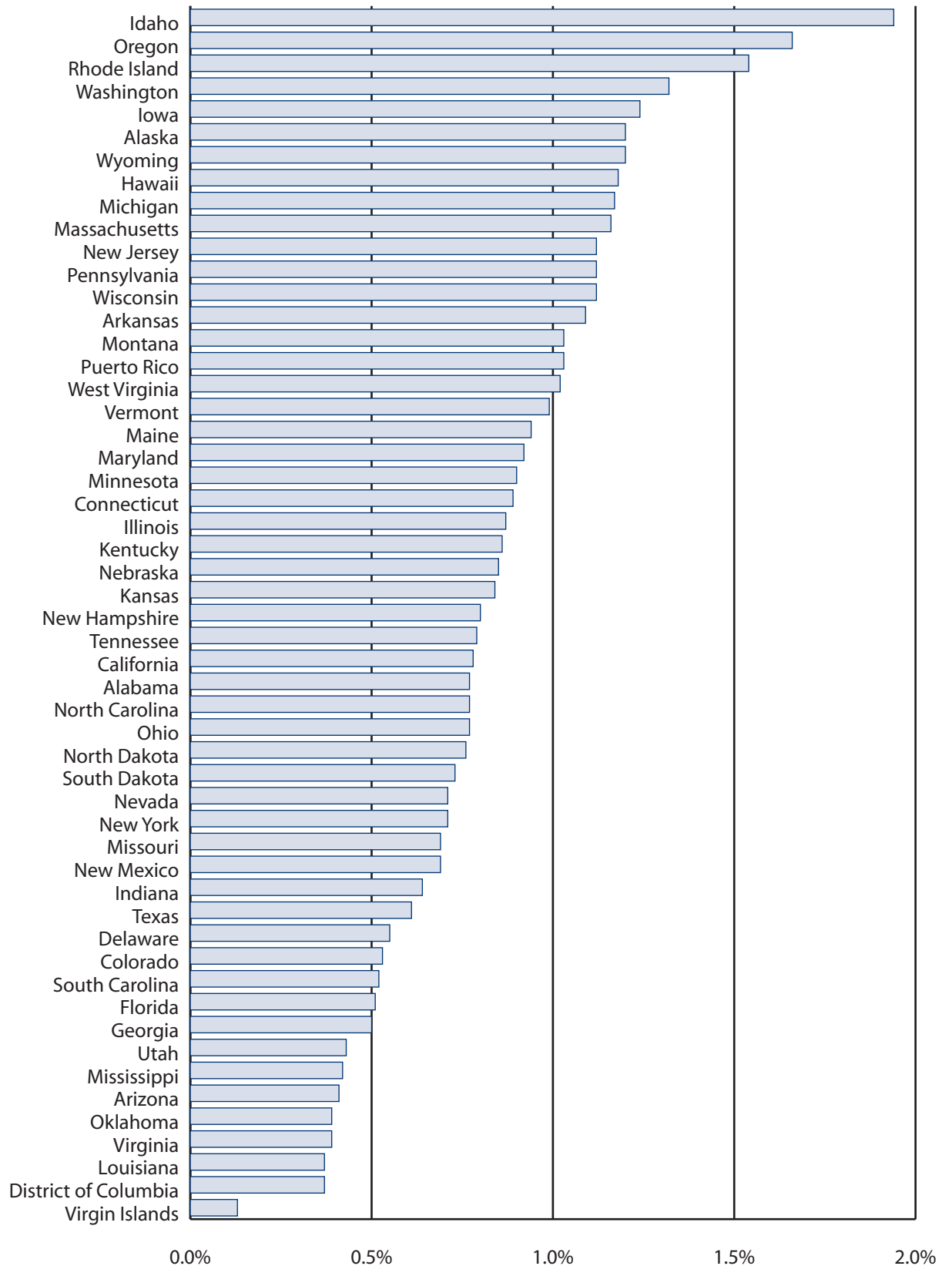
14 See Watters, *supra* note 4, at 23.

15 See U.S. Social Security Board, *supra* note 5.

16 From 1985 to June 30, 2011, the federal UI tax was 6.2 percent. A 0.2 percent “temporary” surtax was enacted in 1976 to reimburse the federal government for extended and supplemental benefits paid during that decade’s recessions. The surtax was repeatedly extended even after repayment was completed in 1987, but finally expired in 2011. See U.S. Government Accountability Office, *Unemployment Insurance: States’ Tax Financing Systems Allow Costs to Be Shared among Industries*, (Jul. 2006), at 5 n.2; Shalleen Mayes, *FUTA Surtax Set to Expire, Adding Confusion for Payroll Managers*, (June 30, 2011), <http://www.patriotsoftware.com/Employer-Training-Blog/bid/39474/FUTA-Surtax-Set-to-Expire-Adding-Confusion-for-Payroll-Managers>. President Obama’s budget proposed making the surtax permanent.

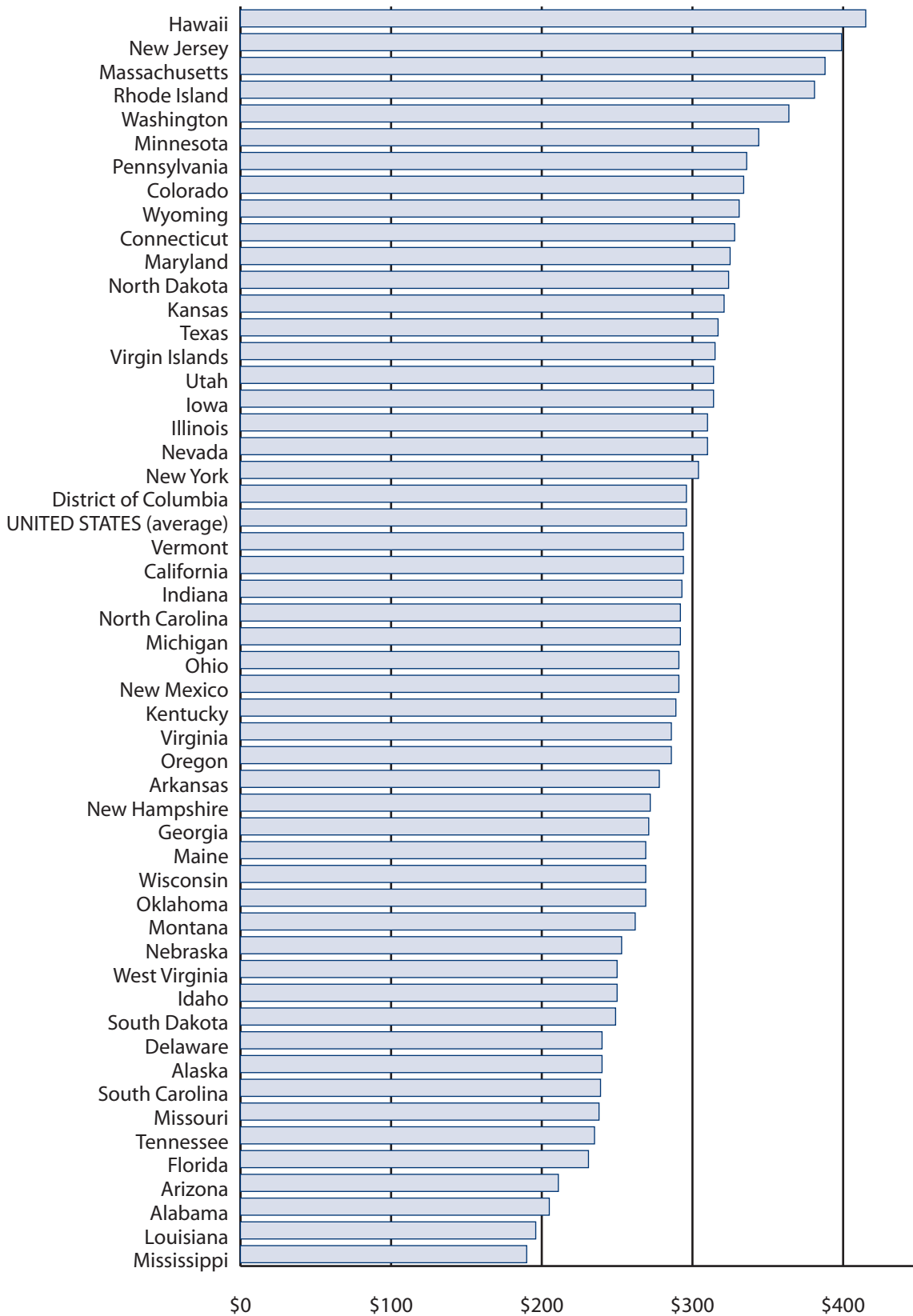
17 In all but three states, the legal incidence of UI taxes falls on employers. The three states where the legal incidence is on employees are Alaska, New Jersey, and Pennsylvania.

Figure 5
Average Unemployment Tax Rate by State
UI Tax Collections as a Percent of All Wages, 2010



Source: U.S. Department of Labor

Figure 6
Average Weekly Unemployment Insurance Benefit by State



Source: U.S. Department of Labor

Table 2
Weeks of Unemployment Benefits by State

State	EUC				SEB	SEB-2/ HEB	Total
	State Benefits	Tier 1 and 2	EUC Tier 3	EUC Tier 4			
Alabama	26	34	13	6	13	7	99
Alaska	26	34	13				73
Arizona	26	34	13	6			79
Arkansas	25	34	13				72
California	26	34	13	6	13	7	99
Colorado	26	34	13	6	13	7	99
Connecticut	26	34	13	6	13	7	99
Delaware	26	34	13		13	7	93
Florida	26	34	13	6	13	7	99
Georgia	26	34	13	6	13	7	99
Hawaii	26	34	13				73
Idaho	26	34	13	6	13	7	99
Illinois	26	34	13	6	13	7	99
Indiana	26	34	13		13	7	93
Iowa	26	34	13				73
Kansas	26	34	13		13		86
Kentucky	26	34	13	6	13	7	99
Louisiana	26	34	13				73
Maine	26	34	13		13		86
Maryland	26	34	13				73
Massachusetts	30	34	13		13		90
Michigan	26	34	13	6	13	7	99
Minnesota	26	34	13		13		86
Mississippi	26	34	13	6			79
Missouri	20	34	13	6	13	7	93
Montana	28	34	13				75
Nebraska	26	34					60
Nevada	26	34	13	6	13	7	99
New Hampshire	26	34					60
New Jersey	26	34	13	6	13	7	99
New Mexico	26	34	13		13		86
New York	26	34	13		13		86
North Carolina	26	34	13	6	13	7	99
North Dakota	26	34					60
Ohio	26	34	13	6	13	7	99
Oklahoma	26	34					60
Oregon	26	34	13	6	13	7	99
Pennsylvania	26	34	13		13		86
Rhode Island	26	34	13	6	13	7	99
South Carolina	20	34	13	6	13	7	93
South Dakota	26	34					60
Tennessee	26	34	13	6	13	7	99
Texas	26	34	13		13	7	93
Utah	26	34	13				73
Vermont	26	34					60
Virginia	26	34	13				73
Washington	26	34	13	6	13	7	99
West Virginia	26	34	13		13	7	93
Wisconsin	26	34	13		13		86
Wyoming	26	34					60
District of Columbia	26	34	13	6	13	7	99
Puerto Rico	26	34	13	6			79
Virgin Islands	26	34	13				73

Note: As of August 2011

Source: Tax Foundation compilation of state data sources

18 See Watters, *supra* note 4, at 1-4. The tax began at 3.0 percent (0.3 percent after credits) in 1939; in 1983, it stood at 6.2 percent (0.8 percent after credits), due to the 0.2 percent federal surcharge that existed between 1985 and June 2011.

19 U.S. Department of Labor, *Comparison of State Unemployment Insurance Laws (Chapter 2)* (2011), <http://workforcsecurity.doleta.gov/unemploy/comparison2011.asp>.

20 U.S. Government Accountability Office, *supra* note 16, at 1.

21 The federal minimum taxable wage base was originally \$3,000; it rose to \$4,200 in 1972; \$6,000 in 1978; and \$7,000 in 1983. In 1938, 98 percent of total wages were under the UI tax ceiling; by 1972 it was 52 percent and by 1983 it was 43 percent. Today, it is less than 30 percent.

the federal share of Extended Unemployment Compensation (EUC) benefits during times of high unemployment, loans to states to pay their share of UI benefits, and some labor information programs.¹⁹

State UI Tax Rates and Taxable Wage Bases

State UI taxes are based on schedules of minimum and maximum rates on a set taxable wage base. The rate employers pay depends on their “experience rating,” a risk-based continuum that varies rates “according to how much or how little their workers received unemployment benefits.”²⁰

Employers with a history of laying off many workers are subject to the maximum rate schedule; employers who have laid off fewer workers are subject to the minimum rate schedule. Minimum rates range from zero (six states) to 2.237 percent (Pennsylvania); maximum rates range from 5.4 percent (11 states) to 13.5576 percent (Pennsylvania). New employers generally pay a fixed rate until they qualify for an experience rating schedule. See Table 1 for minimum rates, maximum rates, and new employer rates by state.

The tax rates are applied to a taxable wage base, or ceiling, set by each state. Six states use a taxable wage base of \$7,000, the minimum for employers to receive federal credits.²¹ The highest wage base is in Washington State, at \$36,800. See Table 1 for taxable wage base by state.

The interaction of maximum rates, minimum rates, and taxable wage base results in different tax burdens on employers in each state. Additionally, in times when unemployment fund reserves are low, states may move all employers to a higher schedule of rates. Figure 5 shows the average UI tax rate paid by employers in each state in 2010, as a percentage of all wages (including those above the UI tax ceilings).

Other Taxes

Other state UI taxes include targeted fund-building or social cost surtaxes (including some that reduce tax rates for low-turnover employers), rate reductions for employers who make voluntary contributions, taxes to repay bonds or interest on

federal loans, and taxes for job training and placement programs.²²

Payment and Duration of Benefits

When an individual applies for unemployment benefits, states determine a weekly benefit amount and duration of benefits. The weekly benefit amount is generally calculated as a percentage of previously earned wages during a designated period of time.²³ In 2011, the average weekly benefit is \$296, or about 36 percent of the average weekly wage. Weekly benefits range from \$190 in Mississippi to \$415 in Hawaii. Figure 6 shows the average weekly benefit by state.

The duration of state-provided benefits has grown over time, rising from 15-16 weeks in the 1930s to generally up to 26 weeks today.²⁴ In addition, beginning in 1958, Congress has often enacted temporary programs providing special extended benefits during periods of high unemployment. For example, in the 1958-59 recession, Congress enacted the Temporary Unemployment Compensation (TUC) program that provided up to an additional 13 weeks of benefits.²⁵

Presently, unemployed persons can under certain circumstances receive up to 99 weeks of benefits. As an individual exhausts each tier of benefits, he moves to the next tier. If the program expires while an individual is in a tier, he continues collecting the remaining benefits in that tier but cannot advance to the next tier. These benefits consist of:

- Up to **26 weeks** of regular **state unemployment benefits** funded by state UI taxes (fewer weeks in some states)
- Up to **53 weeks** from the temporary **Emergency Unemployment Compensation (EUC-08)** program set up in 2008 and funded by federal UI taxes:
 - Up to 20 weeks for EUC Tier 1, in all states
 - Up to 14 weeks for EUC Tier 2, in all states
 - Up to 13 weeks for EUC Tier 3, in states with an unemployment rate of at least 6 percent (currently 43 states, the District

of Columbia, Puerto Rico, and the Virgin Islands)²⁶

- Up to six weeks for EUC Tier 4, in states with an unemployment rate of at least 8.5 percent (currently 22 states, the District of Columbia, and Puerto Rico)²⁷
- Up to **20 weeks** of benefits from the **Extended Benefits (EB)** program with funding shared between federal and state UI sources:
 - Up to 13 weeks in State Extended Benefits (SEB), in states with an unemployment rate of at least 6.5 percent (currently 32 states and the District of Columbia)
 - Up to seven weeks in State Extended Benefits-2/High Extended Benefits, in states with an unemployment rate of at least 8 percent (currently 24 states and the District of Columbia)

*Table 3
States Facing Tax Credit Reductions*

State	Reduction for 2010	Potential Reduction for 2011
Alabama		0.3%
Arkansas		0.3%
California		0.3%
Connecticut		0.3%
Florida		0.3%
Georgia		0.3%
Idaho		0.3%
Illinois		0.3%
Indiana	0.3%	0.6%
Kentucky		0.3%
Michigan	0.6%	0.9%
Minnesota		0.3%
Missouri		0.3%
North Carolina		0.3%
New Jersey		0.3%
Nevada		0.3%
New York		0.3%
Ohio		0.3%
Pennsylvania		0.3%
Rhode Island		0.3%
South Carolina	0.3%	0.6%
Virginia		0.3%
Wisconsin		0.3%
Virgin Islands		0.3%

Source: U.S. Department of Labor.

Note: 2011 reductions assume each state has a loan balance and no changes are made to avoid the reduction.

As of February 2011

22 See U.S. Department of Labor, *supra* note 19 at Chapter 2; Kail Padgitt, *2011 State Business Tax Climate Index*, Tax Foundation Background Paper No. 60 at 56 (2010).

23 For details about state benefit calculation methods, See U.S. Department of Labor, *supra* note 19 at Chapter 3.

24 Massachusetts offers 30 weeks; Montana offers 28 weeks in some situations. Six states have reduced maximum weeks below 26 weeks in the past two years.

25 Social Security Administration, Bulletin (Aug. 1959), <http://www.ssa.gov/policy/docs/ssb/v22n8/v22n8p16.pdf>.

26 As averaged over the previous three months. Alternatively, the tier applies when a state's insured unemployment rate is at least 4 percent.

27 As averaged over the previous three months. Alternatively, the tier applies when a state's insured unemployment rate is at least 6 percent.

Table 4
State UI Changes to Qualify for Federal Stimulus Funds

State	Change Base Period to Include Most Recent Quarter	Payments to Those Seeking Part-Time Work	Allow UI Benefits to Separations Due to Family Reasons	Additional 26 Weeks of Benefits for Training	Dependent Allowances of at Least \$15 Per Week
Alabama					
Alaska	X		X		X
Arizona					
Arkansas	X	X	X		
California	X	X	X		
Colorado	X	X	X		
Connecticut	X		X		X
Delaware	X	X	X		
Florida					
Georgia	X	X		X	
Hawaii	X	X	X		
Idaho	X	X		X	
Illinois	X		X		X
Indiana					
Iowa	X	X		X	
Kansas	X	X		X	
Kentucky					
Louisiana					
Maine	X	X	X	X	
Maryland	X	X		X	
Massachusetts	X			X	X
Michigan	X				
Minnesota	X	X	X		
Mississippi					
Missouri					
Montana	X	X		X	
Nebraska	X	X		X	
Nevada	X	X	X		
New Hampshire	X	X	X		
New Jersey	X	X		X	
New Mexico	X	X			X
New York	X	X	X		
North Carolina	X	X	X		
North Dakota					
Ohio	X				
Oklahoma	X	X	X		
Oregon	X		X	X	
Pennsylvania					
Rhode Island	X		X		X
South Carolina	X	X	X		
South Dakota	X	X		X	
Tennessee	X	X			X
Texas					
Utah	X				
Vermont	X				
Virginia	X				
Washington	X		X	X	
West Virginia	X				
Wisconsin	X		X	X	
Wyoming					
District of Columbia	X	X		X	
Puerto Rico					
Virgin Islands	X	X	X		
No. of States	38	24	20	14	7

Federal law was amended during the current recession to provide for complete federal funding of the EB program through 2011. Some states also offer additional benefits for special circumstances.²⁸

While some states have adopted a number of UI reforms, it is unlikely that a considerable number of states will repay their federal UI loan balances by the deadline. Employers in many states thus could face growing federal UI tax increases.

The EUC program of additional benefits is temporary and has faced several reauthorizations, most recently in late 2010 as part of an agreement that extended the 2001-03 tax cuts.²⁹ That agreement included an extension of the EUC until January 3, 2012; this does not add additional weeks of benefits, but rather preserves the current structure of benefits through 2011. Current beneficiaries would be able to draw benefits in EUC or EB until June 2012.

In times of low unemployment, generally between 2 and 3 million individuals are drawing unemployment benefits at any given time. As of June 2011, 3.6 million individuals were drawing state UI benefits, 3.2 million individuals were drawing EUC benefits, and 0.6 million were drawing EB program benefits, for a total of 7.5 million recipients out of an estimated 14.5 million unemployed.³⁰ Total recipients peaked at 12.1 million in January 2010.³¹

The UI System in the Economic Downturn

Insolvent States Face Higher Federal UI Taxes and Interest Payments

Because unemployment benefits are an entitlement program and must be paid even if the state trust fund is insolvent, states must then either

28 See U.S. Department of Labor, *supra* note 19 at Chapter 4.

29 Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010, Pub. L. No. 111-312 (H.R. 4853) (enacted Dec. 17, 2010).

30 See U.S. Department of Labor, *Weekly Continuing Claims*, <http://ows.doleta.gov/unemploy/docs/persons.xls>.

31 See *id.*

raise the money themselves or borrow from the federal government's share of UI tax revenues.³² Before 1982, these loans were permanently interest-free; that year, federal law was amended to require interest payments each October 1 for the preceding year. Hence, the first set of interest payments is due by October 1, 2011.

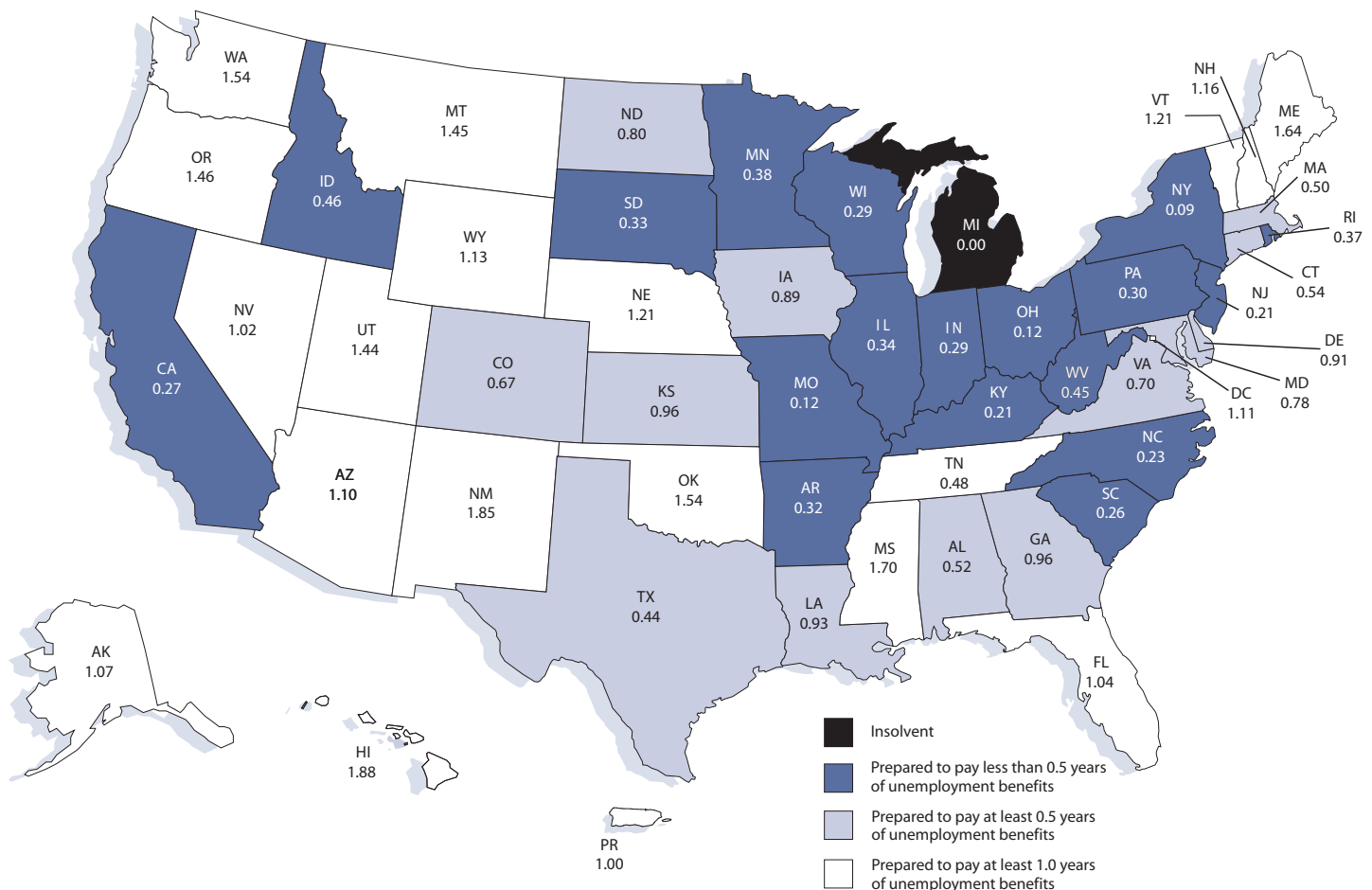
As of September 2011, 34 states had borrowed from the federal government to pay UI benefits. Seven states have repaid their loans in full either through general fund spending or state-based borrowing from the private sector: Hawaii, Idaho, Maryland, Massachusetts, New Hampshire, South Dakota, and Texas.

If a state's UI program is less solvent than it was three years previously, and if the state has not

in the past year begun repaying federal loan balances, employers in the state see their maximum FUTA credits reduced by 0.3 percent per year until the loans are repaid. This higher federal tax is thus a mechanism of automatically repaying those loans. Three states are currently so designated and thus face higher federal UI taxes than 0.8 percent: Indiana (1.1 percent FUTA tax), Michigan (1.4 percent FUTA tax), and South Carolina (1.1 percent FUTA tax).³³

Absent state action to repay federal loan balances or federal action to modify the obligation, 23 states and the U.S. Virgin Islands have been flagged by the Secretary of Labor as likely to see credit reductions this fall, retroactive to January 1, 2011 (see Table 3).³⁴ The Secretary of Labor is

Figure 7
How Prepared Were State Unemployment Fund Reserves at the Beginning of the Current Economic Downturn?
Years of Benefits States Prepared to Pay as of First Quarter 2008



Source: National Association of State Workforce Agencies

Note: Number for each state is the Average High Cost Multiple (AHCM), an official estimate of how many years of high benefit pay-outs a state's trust fund can support.

32 Six states are authorized by their state's laws to issue bonds to pay unemployment insurance, which are then repaid over time. Those states are Colorado, Connecticut, Louisiana, Missouri, Texas, and West Virginia.

33 U.S. Department of Labor, *Reduced FUTA Tax Credits for Tax Year 2010*, http://workforcesecurity.doleta.gov/unemploy/content/reduced_futa.asp.

required to make the determination by November 10 of each year.³⁵ Eventually, a state's employers could lose all of their 5.4 percent in employer tax credits if no part of the interest is paid.

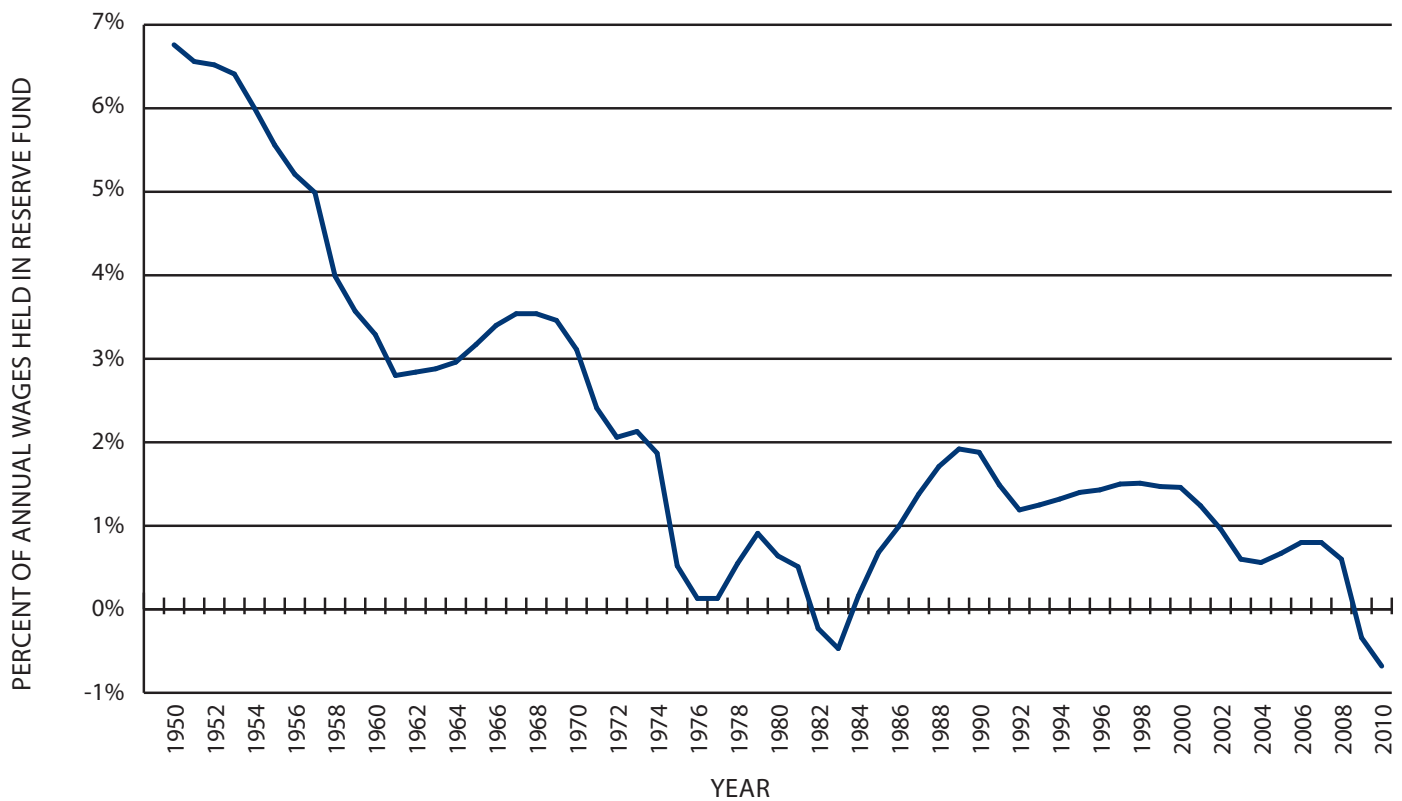
If a state has not made progress toward repaying its loans after three years, an additional credit reduction occurs on top of the 0.3 percent credit reductions, known as the "2.7 add-on."³⁶ This formula reduces credits for employers in states with effective UI tax rates of less than approximately 0.4 percent.³⁷ After five years of non-repayment, the "BCR" credit reduction formula is used instead, which reduces credits for employers in states with high benefit costs relative to taxable wages.³⁸

States can avoid credit reductions by repaying loans at least equal to the amount employers would pay through credit reductions, increasing the solvency of their system by an amount equal

to the credit reductions, repaying any advances in the past year through November 9, and not borrowing between November 1 and January 31 of the following year.³⁹

While some states have adopted a number of UI reforms, it is unlikely that a considerable number of states will repay their federal UI loan balances by the deadline. Employers in many states thus could face growing federal UI tax increases. The author attended the summer 2011 working session on the topic at the National Conference of State Legislatures (NCSL), a gathering of state legislators from around the country, and there was still wide belief that the federal government will either forgive the loan balances or otherwise relieve them by preventing the scheduled tax increases.

Figure 8
Unemployment Insurance Trust Fund Reserves



Source: U.S. Department of Labor.

34 See U.S. Department of Labor, *States with Potential 2011 FUTA Credit Reductions*, http://workforcesecurity.doleta.gov/unemploy/.../reduced_credit_states_2011.xls.

35 See 26 U.S.C. § 2406(f).

36 See 26 U.S.C. § 3302(c)(2)(B).

37 The formula is $[(2.7\% \times 7000 / \text{Avg. U.S. Wage}) - \text{State Effective UI Rate on Total Wages}] \times (\text{State Annual Average Wage} / 7000)$.

38 The Base Credit Reduction (BCR) formula replaces the 2.7% in the above formula if $[\text{Five Year State Average Cost/Taxable Wages}]$ is higher.

39 Ron Wilis, *Trust Fund Loans: Interest Charges and Payment Options*, U.S. Department of Labor, http://www.workforceatm.com/sections/pdf/2010/Peretto_MI_ui75_2010.pdf?CFID=1978765&CFTOKEN=90708802.

Stimulus Package Suspended Interest Payments but Encouraged States to Expand Benefits

The American Recovery and Reinvestment Act of 2009 (ARRA) signed into law in February 2009, also known as the stimulus package, contained several elements that affect unemployment insurance programs.⁴⁰ Chief among these was an extension of the EUC program through the end of 2009; EUC has subsequently been extended to early 2012. Other key provisions:⁴¹

- **Suspended states' requirement to pay interest** on outstanding federal loan balances through 2010. Consequently, beginning on October 1, 2011, states with outstanding federal loan balances must begin paying interest on those balances.
- **Increased weekly benefits** by \$25 per week; this \$12.1 billion in additional benefits was funded entirely by the federal government. This provision expired in late 2010.
- **Exempted the first \$2,400 of unemployment benefits from federal individual income tax** for 2009 only.
- **Expanded to 100 percent** the federal government share for the EB program through early 2012.
- **Provided \$7 billion in UI "modernization incentive payments"** for states that expand UI benefits. To receive a share of the funds, a state must include the most recent quarter of an applicant's earnings in its calculation of benefits, and additionally adopt into law at least two of the following:
 - Pay benefits to those seeking only part-time work
 - Expand UI eligibility to those who leave their job for family reasons (*i.e.*, domestic violence, spousal relocation, caring for a family member)
 - Provide an additional 26 weeks of benefits to those in certain training programs
 - Provide a dependents' allowance of at least \$15 per week

More than half the states received some of the incentive payments, with 34 states receiving full payments. (See Table 4.) As noted by the

U.S. Government Accountability Office (GAO), "changes that states make to state unemployment programs as a result of ARRA's modernization provisions must be permanent, and thus could increase funding challenges for states in the future."⁴² However, the stimulus act does not provide for reclaiming funds from a state if the state subsequently repeals any of the expansion provisions.

President Obama's 2011 Budget Proposal Seeks to Encourage "Forward Funding"

In his February 2011 budget proposal, President Obama advocated a number of UI reforms that would encourage states to better "forward fund" UI liabilities during times of low unemployment.⁴³ The proposal notes that states are not accumulating sufficient UI reserves to withstand recession-level benefits, zeroing in on low taxable wage bases as the key culprit.

The President's proposal would:

- Extend the 0.2 percent federal UI tax surcharge through 2013 (resulting in a 0.8 percent federal UI tax rate after credits). The rate would drop to 0.38 percent in 2014.
- Increase the minimum federal taxable wage base from the current \$7,000 to \$15,000 in 2014, then indexing it to wage growth. Currently, 33 states have taxable wage bases lower than that level, and these would need to be raised.
- Extend the moratorium on state interest payments by two years.
- Delay credit reductions to borrowing states by two years.

The designers of the federal-state unemployment insurance system intended for revenues to exceed expenses during times of low employment, which would enable the accumulation of a large trust fund reserve that could then be drawn down during times of high unemployment. However, over the years states have steadily reduced the amount of reserves built up in good times.⁴⁴

One commonly cited reason is that officials fear that sizeable unemployment reserves will lead to pressure to increase benefits, which in turn

40 American Recovery and Reinvestment Act of 2009, Pub. L. No. 111-5 (enacted Feb. 17, 2009).

41 See U.S. Government Accountability Office, Unemployment Insurance Trust Funds: Long-standing State Financing Policies Have Increased Risk of Insolvency, No. GAO-10-440 at 34-35 (Apr. 2010).

42 Id.

43 See Office of Management and Budget, *supra* note 1, at 111, <http://www.whitehouse.gov/sites/default/files/omb/budget/fy2012/assets/labor.pdf>; U.S. Department of Labor Employment & Training Division, UI Outlook, (Mar. 2011), http://www.ows.doleta.gov/unemploy/content/prez_budget.asp.

would harm the state's ability to pay benefits during times of high unemployment. Consequently, in years leading up to the recession, states have reduced UI taxes and not accumulated reserves during times of low unemployment. For example, between 1995 and 2005, 31 states reduced UI taxes by at least 20 percent.⁴⁵

One measure of trust fund solvency is the "average high cost multiple" (AHCM), which estimates how many years of high benefit pay-outs a state's trust fund can support. For example, a state with an AHCM of 1.0 could support 12 months of historically high benefits. All state reserves had an AHCM of between 1.5 and 2.0 during the 1960s, approximately 1.0 during the late 1990s, and approximately 0.5 just prior to the present recession. In the first quarter of 2008, only 17 states, the District of Columbia, and Puerto Rico were ready to pay one year of high-cost benefits. 20 states had not prepared sufficient reserves to pay even a half year of benefits. (See Figure 7.)

Thus when UI regular and extended benefits rose from \$40.7 billion in 2008 to \$85.8 billion in 2009, built-up state trust fund reserves were not sizeable enough and many states became incapable of paying promised benefits.⁴⁶ Overall UI reserves have fallen steadily over the decades. (See Figure 8.)

If enacted, President Obama's proposal would likely lead to additional money flowing into state UI trust funds while easing obligations in the near term for insolvent states. However, given the proven reluctance of states to accumulate high levels of reserves during times of low unemployment, the proposal may not succeed in its goal of ensuring that UI trust fund reserves are large enough to handle the next recession.

Some States Reducing Benefits or Raising Taxes

Many states have altered UI benefit formulas and eligibility requirements during 2010 and 2011. Six states (Arkansas, Florida, Illinois, Michigan, Missouri, and South Carolina) have reduced the maximum period of state benefits below the previously-universal 26 weeks. Three states (Flor-

ida, Rhode Island, and South Carolina) adopted significant packages of UI reforms.

Florida Reduces Benefit Weeks and Tightens Eligibility Requirements

In June, Florida adopted legislation that makes a number of significant changes to its UI system⁴⁷:

- Benefits are changed from a flat 26 weeks to a sliding scale based on the state's unemployment level. When unemployment is 5 percent or less, recipients can receive up to 12 weeks of benefits. Each 0.5 percent increase in the rate adds another week of benefits, up to a maximum of 23 weeks when unemployment is 10.5 percent or higher (as it is now). This change takes effect January 1, 2012.
- The definition of misconduct, and thus ineligibility for benefits, has been broadened to include specific workplace violations and misconduct outside of working hours.
- Claimants must now provide officials each week with details about at least five prospective employers or a visit to a career center. Claimants must also complete an online skills assessment. This provision is effective August 1, 2011.
- Prisoners are no longer eligible for benefits, as of August 1, 2011.
- Individuals who receive severance pay are no longer eligible for benefits, effective August 1, 2011.
- Appeals officers can now consider certain types of hearsay evidence about claimants, and a rule requiring doubtful cases to be decided in favor of claimants has been repealed.

Rhode Island Reduces Average Weekly Benefit and Tightens Eligibility Requirements

Rhode Island adopted a series of changes that will take effect in July 2012.⁴⁸ The average weekly benefit is expected to drop from approximately \$390 to \$298 through four changes:

44 See Daniel L. Smith & Jeffrey B. Wenger, *If You Build It: State Unemployment Trust Solvency and Benefit Generosity*, Allied Social Science Associations (Jan. 2011), <http://www.martin.uky.edu/workshops/papers/Wenger0126.pdf>. They found only seven states increased their average reserve ratio: Alaska, Delaware, Hawaii, New Jersey, Oklahoma, Oregon, and Vermont. See also Dennis Cauchon, "States Running Out of Money in Jobless Funds," *USA Today* (Sep. 9, 2008).

45 Dale Ziegler, *Introduction to State Unemployment Insurance Trust Fund Solvency*, U.S. Department of Labor (Mar. 19, 2010), <http://www.workforceatm.org/sections/pdf/2010/SolvencyWebinarSlides.pdf?CFID=1970346&CFTOKEN=76052797>.

46 See U.S. Government Accountability Office, *supra* note 41, at 13. Michigan began borrowing in 2006, and Indiana and South Carolina in 2008. New Hampshire did not begin borrowing until 2011.

47 See Florida H.B. 7005 (2011 Leg.).

48 See Rhode Island Laws Ch. 11-151 (11-H 5894A).

- Reducing the maximum weekly rate from 67 percent of average wages to 57.5 percent
- Calculating benefits as replacing 50 percent of lost wages rather than 60 percent (phased in over three years)
- Averaging the two highest quarters in determining a claimant's benefits, rather than using only the highest quarter
- Capping claimants' maximum benefits at 33 percent of all base period wages, rather than 36 percent

Claimants will be disqualified if they are terminated for misconduct, refuse to accept suitable work, quit without good cause, or have not worked at least eight weeks earning at least the benefit rate. Claimants who received severance pay will be disqualified for up to 26 weeks.

Rhode Island also will increase its taxable wage base in 2012 to be indexed to 46.5 percent of the state's average base, resulting in an immediate increase from \$19,000 to \$19,600. High-layoff employers will pay taxes on a higher wage base.⁴⁹

South Carolina Dramatically Expands Experience Rating and Disqualifies Seasonal Employees

A new tier system took effect in 2011 placing employers in one of 20 tiers (up from 15) based on benefit ratio and unemployment claims over the previous seven years. 53 percent of South Carolina businesses have had zero unemployment claims and are in Tier 1 (\$10 per employee per year), a dramatic tax reduction. Businesses with the most unemployment claims are in Tier 20 (\$1,127 per employee per year). Some 30 percent of employers thus saw an increase in UI taxes of 100 percent to 600 percent. New employers are placed in Tier 12 for their first year of operation.

The state will reduce the maximum length of benefits from 26 weeks to 20 weeks, beginning in July 2012. The definition of seasonal employees (ineligible during the off-season) is changed as of January 2012 to regularly recurring periods of 36 consecutive weeks, the longest period used for such a definition. The state also increases the tax-

able wage base from \$7,000 to \$10,000 in 2011, \$12,000 in 2012, and \$14,000 in 2015.

These changes will allow South Carolina to pay back its federal loan and cease additional borrowing. However, critics point to the suddenness of the tax increase and the job reduction impacts for high-turnover employers (hiring freezes, capital investment freezes, layoffs, and threats to move to other states).⁵⁰ The state is also considering reducing benefits for those receiving severance, disqualifying applicants who fail drug tests, and requiring employee contributions.

Reductions in Weeks of Benefits

For the first time in decades, six states cut the maximum length of benefits for qualified claimants to below 26 weeks:

- Arkansas (25 weeks, effective March 2011)
- Florida (a sliding scale of 12 to 23 weeks, effective January 2012)
- Illinois (25 weeks, effective January 2012)
- Michigan (20 weeks, effective January 2012)
- Missouri (20 weeks, effective April 2011)
- South Carolina (20 weeks, effective June 2011)

Other Changes

25 states increased their taxable wage base; the average base in the United States has risen each year: \$11,696 in 2008, \$12,241 in 2009, \$12,970 in 2010, and \$13,451 in 2011. A number of states have also increased minimum and maximum tax rates (20 states in 2010), increased rates for new employers (13 states in 2010), imposed surcharges on all employers (11 states in 2010), and changed maximum and minimum benefits.

Indiana, Georgia, Massachusetts, New Jersey, and South Carolina passed bills canceling or delaying scheduled UI tax increases.⁵¹ Idaho and Texas have borrowed from private sources to pay benefits rather than from the federal government, "replac[ing] federal borrowing costs with (potentially lower) costs of the private bond market, but...not address[ing] structural financing issues."⁵²

49 Id.

50 See Sen. Paul G. Campbell, Jr., *South Carolina: State Unemployment Tax Relief*, Presentation to the National Conference on State Legislatures (Aug. 8, 2011).

51 Indiana House Enrolled Act No. 1450, 117th General Assembly; Georgia Act 95, 2011-2012 Regular Session; Massachusetts Chapter 2 of the Acts of 2011; New Jersey Public Law 2011, Chapter 81; South Carolina Act No. 63, 119th Session.

Issues Associated with the Current Unemployment Insurance Tax System

Experience Rating: Balancing Dual Objectives of Spreading Costs to All Employers and Imposing Costs on High-Turnover Employers

Firms pay higher or lower UI taxes based on their layoff history, known as their **experience rating**. Social insurance programs differ from private insurance in three ways: (1) participation is mandatory, assuring continual new entrants; (2) government operation makes program termina-

tion unlikely, no matter what the actuarial status; (3) taxes, premiums, and benefits can be changed by statute without participants' consent.⁵³ While social insurance programs "may increase somewhat with increased contributions or with increased participation," generally "benefits need not bear a direct relationship to individual contributions."⁵⁴

The UI program thus is a benefit to high-turnover employers, as it enables them to avoid paying higher wages to attract workers who value job stability. Adopting an experience rating formula allows states to claw back some of this benefit, requiring high-turnover firms to bear some of the costs associated with higher benefit payouts to their former workers. Employers with a high experience rating (high turnover and/or large numbers of former employees collecting benefits) must usually pay the maximum state UI tax rate, although these are generally not high enough to cover all the costs. These unrecovered costs "become the common burden of all employers, and for this reason can be referred to as shared costs."⁵⁸ Experience rating has two major goals:

- Use lower taxes to encourage employers to stabilize employment or prevent unemployment
- More accurately distribute the costs of UI benefits to those who impose the costs on society.

There are three types of shared or "socialized" costs. **Ineffective charges** are benefits paid to an employer's former employees in excess of the employer's tax payments, totaling approximately 18 percent of benefits paid in 2009.⁵⁹ **Inactive charges** are "benefits paid to unemployed workers whose former employer has gone out of business,"⁶⁰ totaling 6 percent of benefits paid.⁶¹ **Noncharged benefits** are benefits paid in situations where it is determined that the former employer should not be held responsible, such as where the benefit award is reversed or in some circumstances where the end of employment was due to personal reasons.⁶² Noncharged benefits total 15 percent of benefits paid.⁶³

CALCULATING EACH EMPLOYER'S EXPERIENCE RATING

Four different methods of experience rating (imposing higher UI taxes on employers more likely to impose UI costs on the system) are used by the 53 state and territorial unemployment insurance systems in the United States.

Reserve Ratio, used by 33 systems, accounts for each employer the taxes paid by the employer and the benefits paid to the firm's former employees.⁵⁵ Balances are carried forward and each year, the firm's reserve balance is divided by its wages (usually an average of three years' wages) to calculate its experience rating.

Benefit Ratio, used by 17 systems, divides benefits to a firm's former employees by its wages to calculate its experience rating.⁵⁶ Tax payments by the employer are not considered.

Benefit-Wage Ratio, used by Delaware and Oklahoma, calculates experience rating based on the proportion of the firm's payroll paid to workers who separate during a base period. The higher the ratio, the higher the tax rate. Duration of benefits is thus not a factor in this approach.⁵⁷

Payroll Variation, used by Alaska, bases experience rating on changes to a firm's payroll. Firms with recent layoff activity pay higher rates while firms with no layoffs in the past three years pay the lowest rate.

52 Claire McKenna and George Wentworth, *Unraveling the Unemployment Insurance Lifeline: Responding to Insolvency, States Begin Reducing Benefits and Restricting Eligibility in 2011*, National Employment Law Project Legislative Update at 2 (Aug. 2011), http://nelp.3cdn.net/833c7eeb782f18bdb3_a5m6b0wvp.pdf.

53 See Actuarial Standards Board, *Social Insurance*, Actuarial Standard of Practice No. 32 at 10 (Jan. 1998), http://www.actuarialstandardsboard.org/pdf/asops/asop032_062.pdf.

54 Id.

55 Arizona, Arkansas, California, Colorado, Georgia, Hawaii, Idaho, Indiana, Kansas, Kentucky, Louisiana, Maine, Massachusetts, Missouri, Montana, Nebraska, Nevada, New Hampshire, New Jersey, New Mexico, New York, North Carolina, North Dakota, Ohio, Rhode Island, South Dakota, Tennessee, West Virginia, Wisconsin, and the District of Columbia, Puerto Rico, and the U.S. Virgin Islands.

56 Alabama, Connecticut, Florida, Illinois, Iowa, Maryland, Michigan, Minnesota, Mississippi, Oregon, Pennsylvania, South Carolina, Texas, Utah, Vermont, Virginia, Washington, and Wyoming.

57 See Kevin B. Kerr, *Unemployment Insurance Financing: Selected Issues*, Government of Canada Depository Services Program (Oct. 1994), <http://dsp-psd.pwgsc.gc.ca/Collection-R/LoPBdP/BP/bp389-e.htm>.

58 U.S. Government Accountability Office, *supra* note 16, at 15.

59 National Foundation for Unemployment Compensation & Workers' Compensation, *Fiscal Data for State Unemployment Insurance Systems, 2000-2009* (Oct. 2010) (Table 11).

The United States is the only country that bases its unemployment insurance program on experience ratings.⁶⁴ However, state-set maximum tax rates are generally too low to ensure that experience ratings fully impose on high-turnover employers the cost of benefits to their former employees. Therefore, some cross-subsidization happens in all state systems, just as private insurance usually involves a larger pool of non-claimants paying the costs of providing benefits to the small number of claimants.

Social insurance by definition means shifting the costs of some employers onto all employers as a whole, and experience rating can be an effective tool for this. States should also be cautious about being at either extreme in relying on experience rating:

- Relying too little on experience rating means society is heavily subsidizing employers with highly volatile employment practices, by allowing them to be cost-competitive with more stable employers. The GAO, studying industries in Washington State, found that finance, services, and retailers are likely subsidizing agriculture, fishing, mining, and construction.⁶⁷
- Relying too heavily on experience rating undermines the UI system's objective of spreading the costs of unemployment beyond high-turnover workers. In its 1996 report, the Advisory Council on Unemployment Compensation noted that experience ratings can discourage temporary layoffs, but worried that "such a system often imposes costs on firms precisely when they are in the weakest economic position."⁶⁸ In other words, "some employers—especially small ones—that need to lay off workers may find that their tax rates increase so dramatically as a result of those layoffs that that [sic] additional layoffs become necessary."⁶⁹

The U.S. Department of Labor developed an "Experience Rating Index" (ERI) to calculate to what extent experience rating drives a state's UI system, by calculating the percentage of benefits that are financed out of UI taxes paid by their former employers.⁷⁰ A state with a low ERI (such as Hawaii, Maine, Nevada, South Carolina, and Vermont) means more costs of unemployment

must be shouldered by low-turnover employers and society in general. A state with a high ERI (such as Colorado, Illinois, Minnesota, New York, and North Dakota) puts much of the burden of unemployment on employers who have a history of layoffs. States with an ERI in the middle balance these objectives.

While the Department of Labor ceased calculating ERI in 2005, the National Foundation for Unemployment Compensation & Workers' Compensation (NF/UC/WC) continues to do so. During the period 2000 to 2009, NF/UC/WC calculated overall ERI at between 49 and 64, meaning that between 49 percent and 64 percent of UI benefits paid out are properly charged to the claimant's former employer. Figure 9 shows each state's ERI for 2009.

SOLVENCY TAXES

Solvency taxes are levied on employers when a state's unemployment fund falls below some defined level. These are generally across-the-board taxes imposed on all employers, including new employers in many cases, which undermine experience rating efforts while increasing UI tax burdens and compliance costs. The GAO has criticized solvency taxes, saying that such a tax:

[D]istorts experience rating in that it changes an employer's experience-rated rate relative to those of other employers. For example, an employer with a tax rate of 3 percent would now have a tax rate of 3.9 percent, an effective 30 percent increase. On the other hand, an employer with a 5 percent tax rate would, with the fund-building component added, now have a tax rate of 5.9 percent—an 18 percent increase.⁶⁵

All states except Maryland, New Mexico, North Dakota, and Vermont have statutes automatically imposing surtaxes upon a defined fund balance trigger occurring.

Currently 18 states impose a solvency tax on employers, although they operate under different names: Alaska (solvency adjustment), Arkansas (stabilization tax), Colorado (solvency tax), Delaware (supplemental assessment), Illinois (fund building factor), Louisiana (solvency tax), Massachusetts (secondary adjustment), Minnesota (Additional Assessment & Falling Trust Fund Adjustment), New Hampshire (emergency power surcharge), New Jersey (solvency addition), New York (subsidiary contribution), Oklahoma (temporary surcharge), Pennsylvania (solvency measures), Rhode Island (solvency surtax), Texas (deficit assessment), Virginia (fund building rate), Washington (solvency surcharge), and Wisconsin (solvency rate).⁶⁶

60 U.S. Government Accountability Office, *supra* note 16, at 16.

61 U.S. Department of Labor Office of Workforce Security Division of Fiscal and Actuarial Services, *Significant Measures of State UI Tax Systems 2010* (Oct. 2010), <http://workforsecsecurity.doleta.gov/unemploy/pdf/sigmeasuitaxsys10.pdf>

62 U.S. Government Accountability Office, *supra* note 16, at 16.

63 Additionally, certain nonprofit organizations, government agencies, and Indian tribes may "opt out" of UI tax payments on the condition they "self fund": reimburse the government for any benefit claims from former employees. These "reimbursable employers" total 4 percent of claims paid. See U.S. Department of Labor Office of Workforce Security Division of Fiscal and Actuarial Services, *supra* note 61.

64 U.S. Government Accountability Office, *supra* note 16, at 5.

65 *Id.* at 17.

66 See U.S. Department of Labor, *supra* note 19 at Chapter 2.

States should be sure that their UI tax systems are not overly complex and burdensome, particularly to new employers, and that they balance the goal of spreading the costs of unemployment among all employers, with the danger of overly subsidizing high-turnover employers by enabling them to pay lower wages that do not compensate their workers for lower job security.

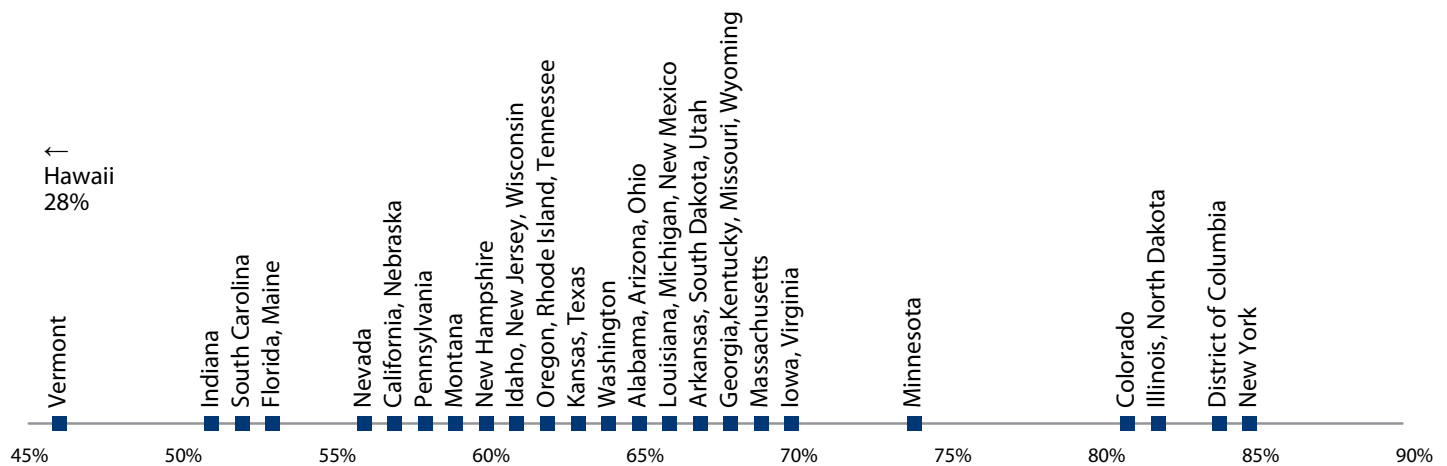
purpose was for UI benefits “to act as a first line of defense in protecting the industrial worker from distress caused by involuntary unemployment.”⁷¹ Even then, they added a second objective: “Unemployment compensation can thus act as a cushion to the downswing of the business cycle when business is beginning to slacken, since it helps to sustain the buying power of the consuming public.”⁷²

Job Creation and Countercyclical Fiscal Policy: Making the Economy Better or Worse?

The Social Security Board’s March 1937 pamphlet explaining the rationale for unemployment insurance emphasized that the overriding

Keynesian economists today refer to such a policy as **countercyclical**—that is, a policy that cools down the economy in an upswing or stimulates an economy in a downswing.⁷³ These commentators assert that UI benefits are countercyclical, and further, that they are effective at retaining and even creating jobs. This conclusion relies on Keynesian economic models’ focus on

Figure 9
Percentage of Paid Benefits Properly Charged to Claimant’s Former Employers Experience Rating Index (ERI), 2009



Lower score (below 60%):

- UI system **penalizes low-turnover** employers with high taxes
- Benefits to laid-off workers borne heavily by all employers
- Employers pay similar taxes

Score in the middle means:

- UI system **penalizes neither** high- nor low-turnover employers
- Benefits to laid-off workers primarily but not exclusively borne by former employers
- Employers pay higher or lower taxes according to their layoff history but without extremely high rates

Higher score (75% or above):

- UI system **penalizes high-turnover** employers with high taxes
- Benefits to laid-off workers borne heavily by their former employer
- Employers pay higher or lower taxes

Note: ERI calculation not available or applicable for Alaska, Connecticut, Delaware, Maryland, Mississippi, North Carolina, Oklahoma, and West Virginia. Source: Department of Labor calculation by the National Foundation for Unemployment & Workers’ Compensation, Fiscal Data for State Unemployment Insurance Systems 2000-2009 (Table 11)(Oct. 2010).

67 U.S. Government Accountability Office, supra note 16, at 21.
 68 Advisory Council on Unemployment Compensation, Collected Findings and Recommendations: 1994-1996 at 39 (1996), <http://research.upjohn.org/cgi/view-content.cgi?article=1000&context=externalpapers>.
 69 U.S. Government Accountability Office, supra note 16, at 28. See also Dr. William B. Conerly, *Getting Back to Work: Reforming Unemployment Insurance to Increase Employment*, Goldwater Institute Policy Report at 5 (Jan. 2004), <http://www.goldwaterinstitute.org/article/1230> (“Researchers have estimated that five percent of all layoffs are due to improper experience ratings. Other researchers focusing only on temporary layoffs found that the system itself caused 20 to 30 percent of such layoffs. At the depth of a recession, poor experience ratings cause about 50 percent of all temporary layoffs.”).
 70 More specifically, the formula is $ERI = (1 - ((\text{Ineffective Charges} + \text{Inactive Charges} + \text{Noncharges}) / \text{Benefits}))$.
 71 U.S. Social Security Board, supra note 5.
 72 Id.

boosting “aggregate demand,” or overall spending in the economy, and the contention that UI benefit recipients are more likely to spend rather than save their benefits. For example, in summer 2010, then-House Speaker Nancy Pelosi argued that an extension of UI benefits “injects demand into the economy...[i]t creates jobs faster than almost any other initiative you can name.”⁷⁴ The U.S. Department of Labor asserts on its website that “for every dollar spent on unemployment insurance, this report finds an increase in economic activity of two dollars.”⁷⁵ Moody’s analyst Mark Zandi, one of the architects of the 2009 stimulus law, states that “every dollar spent on extending unemployment insurance benefits produces \$1.61 in economic activity.”⁷⁶

Critics argue that such “multipliers” (the number of times spending induces other spending) are assumptions built into economics model, rather than evidence produced by the models. In other words, Zandi’s statement that UI benefit payments produce economic effects greater than \$1.00 for every \$1.00 spent (a multiplier of 1.0) is assumed, rather than the conclusion reached from analysis.⁷⁷ Writing in the *Wall Street Journal*, Reagan Administration economist Arthur Laffer responded to Zandi’s claim:

While the unemployed may spend more as a result of higher unemployment benefits, those people from whom the resources are taken will spend less. In an economy, the income effects from a transfer payment always sum to zero. Quite simply, there is no stimulus from higher unemployment benefits.

To see these effects clearly, imagine a two person economy in which one of the two people is paid for being unemployed. From whom do you think the unemployment benefits are taken? The other person obviously. While the

one person who is unemployed may “buy” more as a result of unemployment benefits, the other person from whom the unemployment sums are taken will “buy” less. There is no stimulus for the economy.

But it doesn’t stop there. While the income effects sum to zero, the substitution effects aggregate. The person from whom the unemployment funds are taken will find work less rewarding and will work less. The person who is given the unemployment benefits will also find work relatively less rewarding and will therefore work less. Both people in this two-person economy will be incentivized to work less. There will be less work and more unemployment.⁷⁸

Whether unemployment insurance benefits create net jobs or not, the claim that UI is effective countercyclical policy is belied by the prevalence of UI tax reductions in good economic times and UI tax increases, benefit cuts, and borrowing in bad economic times. All told, 35 states raised UI taxes in 2010 by increasing either the tax rate or the taxable wage base⁷⁹ while fiscal pressures are leading many states to cut benefits. In years leading up to the recession, by contrast, many states reduced UI taxes and did not accumulate reserves during times of low unemployment. For example, between 1995 and 2005, 31 states reduced UI taxes by at least 20 percent.⁸⁰ One study concluded that “[c]hanging demographics, industry mix, and state UI statutes have all contributed over time to create a UI system that is no longer countercyclical and may be counterproductive.”⁸¹ The GAO also concluded that “[l]ong-standing state UI policies and practices have led to trust fund vulnerability.”⁸²

With insufficient accumulated state trust fund reserves, benefit payouts today are financed

73 See, e.g., Martin Feldstein, *The Role for Discretionary Fiscal Policy in a Low Interest Rate Environment*, NBER Working Paper No. 9203 (Sep. 2002), <http://www.nber.org/papers/w9203>.

74 Pelosi: *Unemployment Checks Fastest Way to Create Jobs*, FoxNews.com (Jul. 1, 2010), <http://www.foxnews.com/politics/2010/07/01/pelosi-unemployment-checks-best-way-create-jobs/>.

75 U.S. Department of Labor, Summary: *The Role of Unemployment [Insurance] as an Automatic Stabilizer During a Recession*, (Nov. 2010), <http://www.dol.gov/opa/media/press/eta/eta20101615fs.htm>.

76 Michael Leachman, *January 30 Data Release Will Capture Only a Portion of the Jobs Created or Saved by the Recovery Act*, Center on Budget and Policy Priorities (Jan. 2010), <http://www.cbpp.org/cms/index.cfm?fa=view&id=3069>, citing “The Impact of the Recovery Act on Economic Growth,” Hearing Before the Joint Economic Committee (Oct. 29, 2009) (statement of Mark Zandi).

77 See, e.g., Robert Barro, Keynesian Economics vs. Regular Economics, *Wall Street Journal* (Aug. 24, 2011), <http://online.wsj.com/article/SB10001424053111903596904576516412073445854.html>; Arthur Laffer, Unemployment Benefits Aren’t Stimulus, *Wall Street Journal* (Jul. 8, 2010), http://online.wsj.com/article/NA_WSJ_PUB:SB10001424052748704862404575351301788376276.html; Alan Reynolds, *Can Unemployment Benefits Create Jobs?*, Cato Institute Blog (Jan. 29, 2010), <http://www.cato-at-liberty.org/can-unemployment-benefits-create-jobs/>.

78 Laffer, *supra* note 77.

79 National Association of State Workforce Agencies, *UI Trust Fund Solvency Survey: Summary Document of State Responses*, (Dec. 2009), <http://www.workforceatm.org/sections/pdf/2010/FINALSOLVENCYSURVEY.pdf>.

80 Ziegler, *supra* note 45.

81 Linda M. Aguilar & William A. Testa, *Unemployment Insurance: Countercyclical or Counterproductive*, Chicago Fed Letter No. 47 (Jul. 1991), http://www.chicagofed.org/digital_assets/publications/chicago_fed_letter/1991/cfljuly1991_47.pdf.

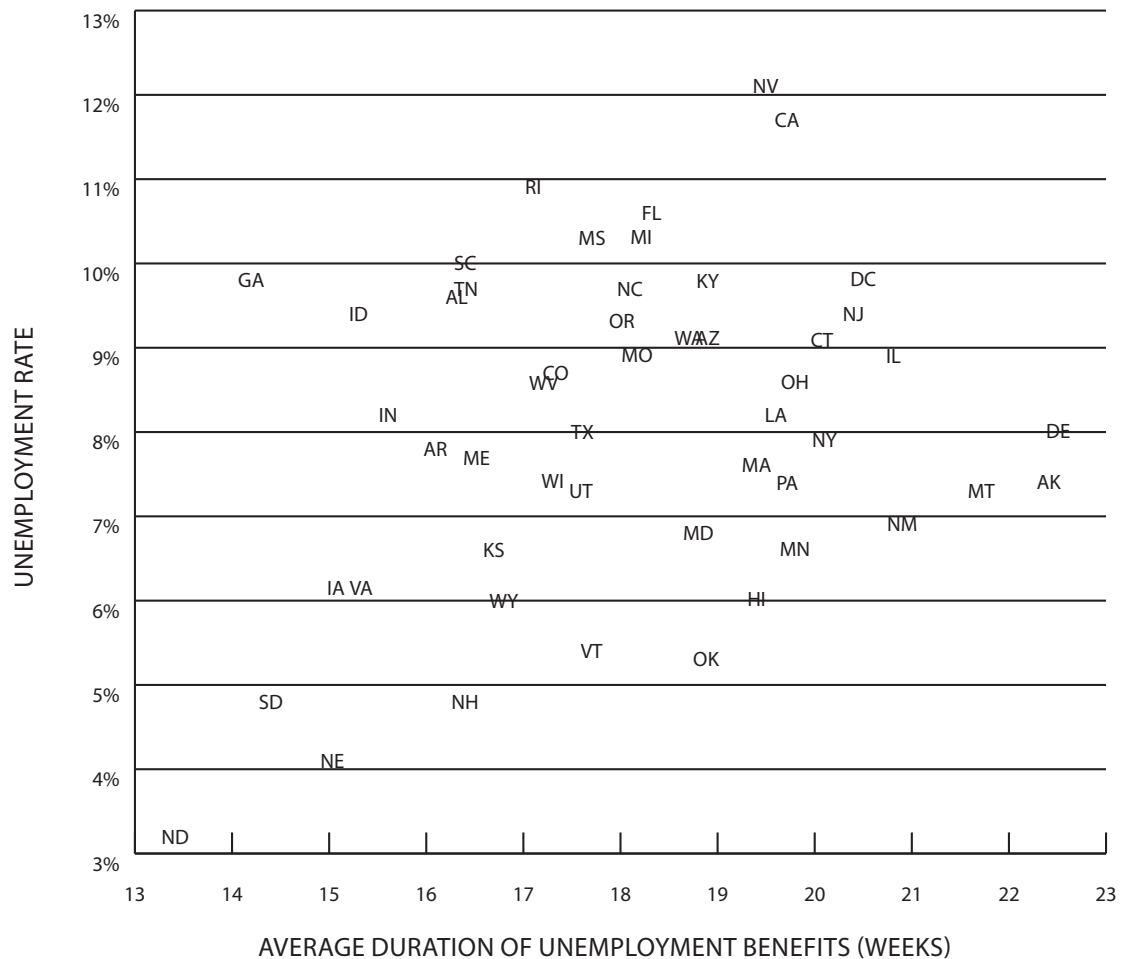
82 U.S. Government Accountability Office, *supra* note 41, at 14.

through current tax revenues and borrowing from private sources or from the federal government, which in turn is borrowing from private or foreign sources. Payments today are made from sources today, rather than from accumulated savings from good economic times. In short, the current UI system is not effective in its original goal of saving funds in good economic times to be drawn down in bad economic times. This is not merely an effect of the severity of the current downturn; the decline in trust fund reserves and pressure to reduce UI taxes in good economic times and increase taxes in bad economic times are long-standing.

Excessive Search and Moral Hazard: Extended Benefits Increase Spending while Also Increasing Unemployment

Debates over proposals to extend or expand unemployment benefits inevitably lead to assertions that generous benefits create a disincentive for beneficiaries to find suitable work quickly, a phenomenon known as **excessive search**.⁸³ Benefits, the argument goes, enable unemployed individuals to turn down or not seek less desirable work, or extend their duration of non-employment beyond what it otherwise would have been. Excessive search is an example of what is called **moral**

Figure 10
Unemployment Rate and Duration of Benefits by State



Source: Tax Foundation compilation

83 A June 2009 *Los Angeles Times* article referred to “funemployment”: “Buoyed by severance, savings, unemployment checks or their parents, the funemployed do not spend their days poring over job listings. They travel on the cheap for weeks. They head back to school or volunteer at the neighborhood soup kitchen. And at least till the bank account dries up, they’re content living for today.” Kimi Yoshino, “For the ‘funemployed,’ unemployment’s welcomed,” *Los Angeles Times* (Jun. 4, 2009), <http://articles.latimes.com/2009/jun/04/local/me-funemployment4>.

hazard: a situation where a party insulated from risk acts differently from the way it would behave if it were fully exposed to the risk.

At the creation of the federal-state UI system, proponents made clear that they were setting up a social insurance program and not a need-based welfare program.

Few deny that excessive search occurs but the extent remains hotly debated. Liberals tend to argue it is a minor problem or not a problem at all; conservatives tend to highlight it as serious. For example, in the 2009 debate over the extension of federal financing of unemployment benefits, Sen. Robert Menendez (D-NJ) responded sharply to an economist who argued that excessive search is a problem:

Dr. Campbell, even if your proposition, your argument, that unemployment benefits incentivize people to remain unemployed is correct under normal economic circumstance—a premise which I personally find highly doubtful given that the average benefit is only about \$325 per week—how do you make that argument in the current economy? How do you deal with the numbers of 3 million, 15 million, and 33 percent? Three million jobs, 15 million people ostensibly looking for jobs, whom you want to incentivize by taking away their unemployment benefits, and 33 percent of those who have been unemployed being unemployed for more than 26 weeks. So are they all lazy?⁸⁴

Sen. Jon Kyl (R-AZ) urged opposition to the federal benefits extension on moral hazard grounds:

That doesn't create new jobs. In fact, if anything, continuing to pay people unemployment compensation is a disincentive for them to seek new work. I'm sure most of them would like work and probably have tried to seek it, but you can't argue that it's a job enhancer. If anything, as I said, it's a disincentive.⁸⁵

Economics Professor Ken Rogoff of Harvard University does not deny the effect generally but

argues that the present economic situation is a special circumstance:

Well, there's certainly a truth to it, and many people believe that's why Europe, with much more generous benefits, has higher unemployment. But today, we're in a once-every-50-years, once-every-75-years recession. There just aren't a lot of jobs.

And it's hard to believe that that's really what's holding people back from getting them, that they can collect a modest unemployment check.[...]

[Conservatives are] making a correct point, but they're stretching it. The empirical work suggests that maybe if you get an extra week of unemployment benefits, your unemployment lasts a day longer, and that's in normal times.

I think it's important to have some checks and balances, not to get carried away. But they're really taking a small point and stretching it out into something bigger than it is.⁸⁶

Similarly, liberal commentator Paul Krugman today argues that “what textbook economics says [is] that when the economy is deeply depressed, extending unemployment benefits not only helps those in need, it also reduces unemployment.”⁸⁷ His own textbook (co-authored with his wife), *Macroeconomics*, does not have such a caveat.

[P]ublic policy designed to help workers who lose their jobs can lead to structural unemployment as an unintended side effect. Most economically advanced countries provide benefits to laid-off workers as a way to tide them over until they find a new job. In the United States, these benefits typically replace only a small fraction of a worker's income and expire after 26 weeks. In other countries, particularly in Europe, benefits are more generous and last longer. The drawback to this generosity is that it reduces a worker's incentive to quickly find a new job. Generous unemployment benefits in some European countries are widely believed to be one of the main causes of “Eurosclerosis,” the persistent high unemployment that affects a number of European countries.⁸⁸

A 2005 survey piece by Raj Chetty of UC Berkeley and the National Bureau of Economic

⁸⁴ *Unemployment Insurance Benefits: Where Do We Go From Here?*, Hearing Before the Senate Committee on Finance, 111th Cong. 956 at 20 (2009).

⁸⁵ *The Controversy Over Extending Jobless Benefits*, NPR All Things Considered (Jul. 12, 2010), <http://www.npr.org/templates/story/story.php?storyId=128470510>.

⁸⁶ Id.

⁸⁷ Paul Krugman, *Senator Bunning's Universe*, New York Times (Mar. 5, 2010).

⁸⁸ Paul Krugman & Robin Wells, *Macroeconomics* at 210 (2d ed. 2009).

Research summarized the relevant academic findings:⁸⁹

- Moffitt (1985), Meyer (1990), and others have shown that a 10 percent increase in unemployment benefits raises average unemployment durations by 4-8 percent in the U.S.⁹⁰
- Krueger and Meyer (2002) remark that behavioral responses to UI and other social insurance programs are large because they “lead to short-run variation in wages with mostly a substitution effect”[:] distorting the relative price of leisure and consumption, reducing the marginal incentive to search for a job.⁹¹
- Gruber (2007) notes that “UI has a significant moral hazard cost in terms of subsidizing unproductive leisure.”

Other key findings on the subject:

- Feldstein & Poterba (1984) found that one quarter of unemployed individuals did not take a new job unless it paid at least 10 percent more than the wage at their previous job. They concluded that more generous UI benefits increase this **reservation wage** (wage at which a person will take a job): a 10 percent increase in unemployment benefits increases the reservation wage by 4 percent. They said the results “imply that reducing net unemployment insurance benefits could significantly lower the average duration of unemployment and the relative number of long duration spells of unemployment.”⁹²
- Solon (1985) found that subjecting high-income individuals’ unemployment benefits to income tax in 1979 led to those beneficiaries reducing the duration of their unemployment by one week.⁹³
- Ham and Rea (1987) found that unemployed workers not receiving benefits are increasingly likely to find jobs as time goes on, while the

opposite is true of unemployed workers who do receive benefits.⁹⁴

- Katz & Meyer (1988) found that extending UI benefits from 6 months to 12 months would likely increase the duration of unemployment by one month.⁹⁵

In a 2008 article, economist and Clinton Administration Treasury Secretary Lawrence H. Summers references the reservation wage: “the minimum wage [an unemployed person] insists on getting before accepting a job. Unemployment insurance and other social insurance programs increase that reservation wage, causing an unemployed person to remain unemployed longer.”⁹⁶ Summers estimates that if an individual could choose between working for \$15 per hour and collecting unemployment insurance at \$8.25 per hour, the cost of unemployment to the person was only \$4.39 per hour (after accounting for taxes) while the cost to taxpayers and the economy as a whole was much larger. Summers also “estimated that the existence of unemployment insurance almost doubles the number of unemployment spells lasting more than three months. If unemployment insurance were eliminated, the unemployment rate would drop by more than half a percentage point...”⁹⁷

Krueger & Mueller (2008) reviewed the amount of time that unemployed individuals in different states and countries spent on job search activities, finding that “the average unemployed worker in the U.S. devotes about 41 minutes to job search on weekdays, which is substantially more than his or her European counterpart” and that “job search is inversely related to the generosity of unemployment benefits.”⁹⁸ They reiterated the finding of Mortensen (1977) that “job search increases sharply in the weeks prior to benefit exhaustion” for those receiving UI benefits, while job search remains constant for those not eligible to receive UI benefits.⁹⁹

89 Raj Chetty, *Why do Unemployment Benefits Raise Unemployment Durations? The Role of Borrowing Constraints and Income Effects*, (Nov. 2005), http://emlab.berkeley.edu/users/webfac/quigley/e231_f05/chetty.pdf.

90 Robert Moffitt, Unemployment Insurance and the Distribution of Unemployment Spells, 28 *Journal of Econometrics* 1, 85-101 (1985); Bruce Meyer, Unemployment Insurance and Unemployment Spells, 58 *Econometrica* 4, 757-82 (1990).

91 Alan B. Krueger & Bruce D. Meyer, Labor Supply Effects of Social Insurance, *NBER Working Paper* No. w9014 (Jun. 2002), <http://papers.ssrn.com/sol3/papers.cfm?abstractid=316793>.

92 Martin Feldstein & James Poterba, Unemployment insurance and reservation wages, 23 *Journal of Public Economics* 1-2, 141-67 (Feb.-Mar. 1984).

93 Gary Solon, Work Incentive Effects of Taxing Unemployment Benefits, 53 *Econometrica* 2, 295 (Mar. 1985).

94 John C. Ham & Samuel A. Rea, Jr., “Unemployment Insurance and Male Unemployment Duration in Canada,” 5 *Journal of Labor Economics* 3, 325-53 (Jul. 1987).

95 Lawrence F. Katz and Bruce D. Meyer, The Impact of the Potential Duration of Unemployment Benefits on the Duration of Unemployment, *NBER Working Paper* No. 2741 (Oct. 1988).

96 Lawrence H. Summers, Unemployment, in *The Concise Encyclopedia of Economics* (2008), <http://www.econlib.org/library/Enc/Unemployment.html>.

97 Id.

98 Alan B. Krueger & Andreas Mueller, Job Search and Unemployment Insurance: New Evidence from Time Use Data, *Institute for the Study of Labor Discussion Paper Series* (Aug. 2008), <http://politiquessociales.net/IMG/pdf/dp3667.pdf>.

99 Id., citing Dale T. Mortensen, Unemployment insurance and job search decisions, 30 *Industrial & Labor Relations Rev.* 4 505-17 (Jul. 1977).

Another study suggests that excessive search occurs regardless of regional economic circumstances. Jurajda and Tannery (2003) compared the effect of federal UI benefits between a relatively prosperous and a relatively depressed area over a multi-year period, finding “only weak support for the presence of stronger UI disincentive effects in tighter labor markets.”¹⁰⁰ Noting that “almost a third of workers who exhausted benefits managed to find work in the next week,” the study concludes that “[t]he strategic impact of exhausting benefits therefore appears to have been similar across demand conditions.”¹⁰¹

Chetty (2007 & 2008) accepted that UI benefits lead to longer unemployment durations (10 percent increase in benefits leads to 4 to 8 percent increase in duration) but argued that this is a larger factor in households with more cash on hand; former employees who had worked for a while tend to stay unemployed longer than former employees who had worked for a shorter period of time (and presumably had fewer liquid assets).¹⁰²

A number of studies examine excessive search particularly in the context of recessions, finding different results (e.g., Ljungqvist & Sargent (1998, 2008) finding a larger effect; Krueger & Meyer (2002) finding a smaller effect).¹⁰³ Recent work by the Federal Reserve Bank of San Francisco, for example, estimates that without federal UI extensions, the unemployment rate in December 2009 would have been 9.6 percent instead of 10 percent.¹⁰⁴ It is therefore likely that extending unemployment benefits does increase consumer spending (and government debt, as benefit payments are at present borrowed by governments for the most part) but also modestly increases the unemployment rate. See Figure 10 for a comparison of unemployment benefits and average duration of benefits by state.

Eligibility: Unemployment Insurance Steadily Drifting Away from Social Insurance toward a Need-Based Program

At the creation of the federal-state UI system, proponents made clear that they were setting up a social insurance program and not a need-based welfare program:

It is designed to compensate only employable persons who are able and willing to work and who are unemployed through no fault of their own....

[It] is not a system under which every unemployed person is assured of benefits for any and all unemployed time. It provides protection primarily for the person who normally is steadily employed. It can take care of the seasonal worker or the intermittently employed person only for very limited periods of time. It makes no attempt to protect unemployable persons such as those who are so old or

SUBSIDIZING SEASONAL EMPLOYERS

Some states deliberately use unemployment benefits as a way to subsidize seasonal employers by effectively reducing the wages they must pay to seasonal workers. California, for instance, intentionally uses its unemployment insurance program to subsidize agricultural production. As explained by the U.S. Government Accountability Office (GAO):

[B]enefits paid during the off-season became [after 1985] an essential part of an agricultural worker’s annual income.... [A] pattern of a working season, followed by a period of subsisting on unemployment benefits, followed by another working season, has become the norm for many of these workers.¹⁰⁹

The use of the program in such a manner permits the agricultural sector to offer lower wages to its seasonal employees, subsidized by higher UI costs to employers and society as a whole.

Sixteen states provide benefits to seasonal workers: Arizona, Arkansas, Colorado, Delaware, Indiana, Maine, Massachusetts, Michigan, Mississippi, North Carolina, Ohio, Pennsylvania, South Dakota, Utah, West Virginia, and Wisconsin. Only Wisconsin attempts to cover the additional costs of ongoing UI benefits during the off-season with a tax on seasonal employers.

100 Stepan Jurajda & Frederick J. Tannery, Unemployment Durations and Extended Unemployment Benefits in Local Labor Markets, *56 Industrial & Labor Relations Rev.* 2, 343 (Jan. 2003).

101 Id.

102 David Card, Raj Chetty, & Andrew Weber, Cash-on-Hand and Competing Models of Intertemporal Behavior: New Evidence from the Labor Market, *122 Quarterly Journal of Economics* 4, 1511-60 (2007); Raj Chetty, Moral Hazard vs. Liquidity and Optimal Unemployment Insurance, *116 Journal of Political Economy* 2, 173-234 (2008).

103 L. Ljungqvist & T. Sargent, The European unemployment dilemma, *106 Journal of Political Economy* 514-50 (1998); Krueger & Meyer, *supra* note 91.

104 Rob Valleria & Katherine Kuang, Extended Unemployment and UI Benefits, *Federal Reserve Bank of San Francisco Economic Letter* (Apr. 19, 2010), <http://www.frbsf.org/publications/economics/letter/2010/el2010-12.html>. See also Felix Salmon, The effect of unemployment insurance on unemployment, Reuters (Dec. 9, 2010), <http://blogs.reuters.com/felix-salmon/2010/12/09/the-effect-of-unemployment-insurance-on-unemployment>.

Table 5
Work Search Requirements

State	Contacts per Week Required to Maintain Eligibility
Alabama	No Minimum
Alaska	1
Arizona	No Minimum
Arkansas	1
California	No Minimum
Colorado	No Minimum
Connecticut	3
Delaware	1
Florida	5
Georgia	2
Hawaii	3
Idaho	2
Illinois	No Minimum
Indiana	3
Iowa	2
Kansas	1
Kentucky	1
Louisiana	1
Maine	No Minimum
Maryland	2
Massachusetts	3
Michigan	No Minimum
Minnesota	No Minimum
Mississippi	2
Missouri	3
Montana	1
Nebraska	2
Nevada	3-5
New Hampshire	No Minimum
New Jersey	3
New Mexico	2
New York	No Minimum
North Carolina	2
North Dakota	2
Ohio	1
Oklahoma	2
Oregon	No Minimum
Pennsylvania	2
Rhode Island	3
South Carolina	No Minimum
South Dakota	2
Tennessee	2
Texas	Varies by Claimant
Utah	4
Vermont	3
Virginia	2
Washington	3
West Virginia	2
Wisconsin	2
Wyoming	2
District of Columbia	2
Puerto Rico	3

Source: National Foundation for Unemployment Compensation & Workers' Compensation

handicapped physically that they are unable to work.¹⁰⁵

These eligibility restrictions generally serve the purpose of keeping the program tied to its objective of socializing the costs of involuntary unemployment, enabling the worker laid off through no fault of his or her own to maintain a basic standard of living while transitioning between jobs.

There are four main eligibility standards:

- **Previously a member of the labor force**, as demonstrated by an appropriate employment history. All states require that a beneficiary must have earned a specified amount of wages or must have worked a designated period of time, known as the base period.¹⁰⁶ Part-time workers are excluded as they pay less into the system, families were historically unlikely to be put into poverty on the loss of a part-time job and because it is difficult to police against part-time workers seeking to game the UI system.¹⁰⁷
- **Able and available for work**. This requirement is subject to wide variation, with many states specifying only that an individual be able and available only for “suitable work,” defined as something similar to prior training and experience. Seasonal workers, retirees, mobile workers, students, or those traveling or in the hospital are generally excluded under this standard. Refusing suitable work also can lead to postponement, reduction, or denial of benefits.¹⁰⁸
- Federal law prohibits punishing a beneficiary for refusing work as a strike replacement worker, work substantially inferior to other area jobs in wages or work conditions, or work that requires union membership as a condition of employment.

105 U.S. Social Security Board, *supra* note 5.

106 The base period in the United States is generally earnings during the first four of the last five calendar quarters. This is to prevent situations like the “Lotto 10/40” in Canada, where one may work for 10 weeks and then become eligible for up to 40 weeks of UI benefits. See Conerly, *supra* note 69, at 10.

107 See Conerly, *supra* note 69, at 11 (“For example, a job applicant might become very inflexible: claiming to only be available for selective hours for any particular job, guaranteeing that the search for a job continues indefinitely.”).

108 See *National Foundation for Unemployment Compensation & Workers' Compensation, Highlights of State Unemployment Compensation Laws* (2011) (Table 28).

109 U.S. Government Accountability Office, *supra* note 16, at 29.

- **Unemployment is involuntary**, through no fault of the claimant. Analogous to refusing to honor fire insurance for a property owner who sets fire to his building, those who quit their job or are dismissed for cause or misconduct are disqualified from receiving UI benefits until they work another job for a minimum time period.¹¹⁰ Many states also offer more stringent disqualifications for those fired for criminal behavior, such as cancelling all previous wage credits for future benefit calculation.¹¹¹ Adjudication of these standards can be difficult in practice if the employer and employee dispute whether the conduct violated company policy. The National Federation of Independent Business, for instance, points out that “many departing employees automatically file for unemployment compensation. They have nothing to lose; filing a claim costs nothing and it puts the ball in the employer’s court.”¹¹² Indeed, unemployment benefits are awarded if the employer does not respond; if the employer objects, an administrative judge issues a ruling at a hearing.

States also have different rules with regard to leaving work due to illness, compulsory retirement, or quitting due to spousal moving or illness.¹¹³ For labor disputes (strikes and lockouts), many states postpone benefits with waiting periods but ultimately provide them, to prevent serious drains on reserves and maintain a certain neutrality with reference to labor issues.¹¹⁴

- **Actively seeking work**, or making a reasonable effort to find a job. In addition to being ready to accept an offered job, every state also requires that the beneficiary demonstrate active efforts to find a job. All states count in-person and Internet-based job inquiries for the work search requirement, and all states except Arizona, Vermont, and Virginia count telephone inquiries.¹¹⁵

States vary in how many job contacts they require each week (see Table 5). Four states

impose a work search requirement but explicitly do not verify the documentation: Delaware (verifies EB claims only), Minnesota, Missouri, and New Jersey.¹¹⁶

Efforts to reorient the program towards a need-based welfare program ... blur its insurance feature as a benefit that people pay into and then use, and increase the overall cost.

Fraud is a basis for disqualification or even enhanced penalties. Typical UI fraud includes receiving benefits while not reporting earnings or cash earned “under the table,” being self-employed, or being in prison, out of town, or otherwise unavailable for work. All states also disqualify illegal immigrants, professional athletes during the off-season, school employees during summer, and full-time students enrolled in universities.¹¹⁷

These eligibility restrictions generally serve the purpose of keeping the program tied to its objective of socializing the costs of involuntary unemployment, enabling the worker laid off through no fault of his or her own to maintain a basic standard of living while transitioning between jobs. Efforts to reorient the program towards a need-based welfare program—evident in the federal government’s pressure for states to pay benefits to part-time workers, pay benefits to workers in training programs, pay benefits to workers who leave due to spousal moving, and pay additional benefits to claimants with dependents—blur its insurance feature as a benefit that people pay into and then use, and increase the overall cost.

110 See *National Foundation for Unemployment Compensation & Workers’ Compensation*, supra note 108, (Table 27).

111 *Id.*

112 National Federation of Independent Business, *Unemployment Compensation: Start Controlling Your Costs Today*, <http://www.nfib.com/business-resources/business-resources-item?cmsid=49702>.

113 See *National Foundation for Unemployment Compensation & Workers’ Compensation*, supra note 108, (Table 26 & 31).

114 *Id.* (Table 29).

115 *Id.* (Table 33).

116 *Id.*

117 *Id.* (Table 31).

Waiting Week: Discouraging Non-essential Claims and Encouraging Worker Saving

Insurance programs often require a “co-payment” or “deductible” of some amount that must be paid by the beneficiary before the insurance pays out. For example, a health insurance policy with a \$1,000 deductible would require that the beneficiary pay out of pocket all medical costs up to \$1,000 per year; the insurance company would cover all costs above that amount. Co-payments and deductibles make people think twice about filing a minor claim, lowering overall costs and reducing unnecessary claim processing. They ensure that beneficiaries do not rely entirely on the insurance program, taking actions to minimize or avoid out-of-pocket costs (again, **moral hazard**).

A significant roadblock preventing innovation in the federal-state UI system is the “firewall” between administrative funds and benefit funds. ... The price of such a strict federally required “firewall” is to impede state efforts that could be more effective at getting people back to work.

A waiting week serves as a “deductible” for UI programs: most states do not begin paying benefits until one week after either job loss or filing for unemployment. Thirteen states do not impose a waiting week: Alabama, Connecticut, Delaware, Georgia, Iowa, Kentucky, Maryland, Michigan, Nevada, New Jersey, Vermont, Wisconsin, and Wyoming.¹¹⁸ In these states, employees do not have an obligation to rely on their own resources for a brief period of time before turning to tax-financed support, with benefits available even to the shortest transition periods between jobs. A UI tax reform task force in New Jersey, a state

that abolished its waiting week in 2002, noted a “correlation between a modification in the waiting week and claims related to school-related and/or seasonal employment....”¹¹⁹ They estimated UI program savings of \$56 to \$59 million annually if the waiting week were reinstated.

In the private sector, a zero deductible insurance policy is usually accompanied by a higher premium. States that do not require a waiting week consequently will face more nonessential claims and higher costs than states that do require a waiting week, and may discourage workers from saving in anticipation of potential job loss.¹²⁰

Full Federal Reimbursement of Costs Impedes Innovations within the Existing Program

A significant roadblock preventing innovation in the federal-state UI system is the “firewall” between administrative funds and benefit funds. The federal UI tax paid by employers is used to finance federal loans to states and reimburse states for administrative costs.¹²¹ This creates an incentive problem, as explained by UI expert William B. Conerly in his analysis of Arizona UI reforms:

The federal funds DES [Arizona Department of Economic Security] receives for administration are based on workload, measured by administrative functions such as claims processed, benefits paid, and appeals hearings held. If the department were to find better ways to help the unemployed, it would lose funding.

The federal role in funding administration also creates a “two bucket” problem. Money for administration comes from one bucket while the money that pays out benefits to the unemployed comes from another bucket. Because there is a “firewall” between the buckets, there is no incentive to meaningfully monitor recipients or otherwise prioritize administrative resources in the interest of total fiscal savings. If DES finds a way to save three dollars in benefits at a cost of one extra dollar in administration, there is no way to implement the solution. Administrative dollars are limited

118 *Id.* (Table 19).

119 *New Jersey Department of Labor and Workforce Development, New Jersey Unemployment Insurance Task Force Report* (Feb. 2011), http://lwd.dol.state.nj.us/labor/forms_pdfs/lwdhome/press/2011/UITaskForceReport2011.pdf.

120 See Eric M. Engen & Jonathan Gruber, *Unemployment Insurance and Precautionary Saving* (Jun. 1998), <http://econ-www.mit.edu/files/99> (“[R]educing the UI benefit replacement rate by 50 percent would increase the gross financial asset holdings by 14 percent, or \$241, for the average worker. We also find empirical evidence that this ‘crowd out’ effect of UI on household saving is stronger for those facing higher unemployment risk and weaker for older workers....”).

121 Of course, it must be remembered that “federal UI taxes” and “state UI taxes” are paid by the same people: employers. The economic incidence of the tax likely falls heavily on workers, as they are a cost considered by employers when hiring.

and benefit savings cannot be converted into administrative funds.¹²²

The workers' compensation system could be a working model for a wholesale reform of the unemployment insurance system, moving it away from a single-provider model.

Proponents of the status quo see value in the federal government reimbursing states from a national pool, as this allows the country as a whole to support those states that have weaker economies, smaller populations, or higher processing costs. Additionally, under the current system, administrative costs cannot “compete” with benefit costs or other state funding priorities. However, the price of such a strict federally required “firewall” is to impede state efforts that could be more effective at getting people back to work. These ideas, discouraged by the existing system, include:

- **Work options:** Requiring long-term UI beneficiaries to engage in available short-term or part-time work while receiving their UI benefits and searching for full-time work. Oregon has had success offering a subsidy to employers to create new positions for unemployed individuals at the lower end of the experience and training scale, mentoring the new employees and getting them working sooner.¹²³ The Georgia Works program offers to trainees a stipend to cover childcare and transportation expenses while undergoing eight weeks of on-the-job training with an employer, and was highlighted by President Obama as a possible innovation option.¹²⁴
- **Active case management:** Counselors work one-on-one with the unemployed to help them find work. This could help direct state unemployment offices toward viewing their mission as putting people to work, as opposed to just

paying out benefits. A trial program in Arizona estimated a \$14.94 savings in benefit costs for each additional \$1 in administrative costs.¹²⁵

Requiring face-to-face goal and monitoring sessions with unemployment officials after a certain number of weeks, rather than just Internet and phone-based contact, “discouraged procrastination and provided emotional support for the workers’ job search efforts.”¹²⁶

- **Mandatory job search seminars and assessments** for claimants identified as likely to exhaust their benefits before becoming reemployed. These have been shown to be effective, although it appears that the requirement to attend a mandatory seminar induced reemployment more than the information at the seminar itself. In one study, “[r]eemployment was found to occur between the time that notice of the mandatory seminar was given and the time of the seminar.”¹²⁷
- **Offering bonuses to workers who find new jobs quickly**, which when tested in four states was found to be strongly effective at inducing reemployment but not in reducing costs (unemployed people who would not have previously filed did so, to take advantage of the bonus program).¹²⁸ Curiously, nearly half of the subjects returned to their last employer, suggesting the program would discourage temporary layoffs.
- **Fraud prevention efforts:** Many states have a “New Hires” database, often used for tracking down individuals behind on child support payments, but they could also be used to identify individuals receiving improper UI payments. Improving communications between employers and the government could also reduce fraud. However, unless savings from benefits could be moved to fund administration costs (or vice versa), the state has no incentive to engage in such anti-fraud efforts.

A 2002 Bush Administration proposal (“New Balance”) to devolve the UI system completely to the states failed to be considered. Intermediate options that could be considered now include using

122 Conerly, *supra* note 69.

123 See Conerly, *supra* note 69, at 15.

124 See, e.g., Errin Haines, “President Obama puts Georgia Works on jobs agenda,” *Associated Press* (Sep. 8, 2011), <http://www.chron.com/news/article/President-Obama-puts-Georgia-Works-on-jobs-agenda-2162082.php>.

125 See *Arizona Department of Economic Security, Reemployment Services Performance Report* (Dec. 23, 2002) (estimating program costs of \$330,636 but benefit savings of \$4,940,213).

126 Dr. William B. Conerly, *Unemployment Insurance in a Free Society, National Center for Policy Analysis Policy Report No. 274* at 14 (Mar. 2005), <http://www.ncpa.org/pub/st/st274>.

127 Conerly, *supra* note 69, at 5, citing David E. Balducchi, Terry R. Johnson & R. Mark Gritz, *The Role of the Employment Service, in Unemployment Insurance in the United States*, (Christopher O’Leary & Stephen A. Wandner eds.) (1997).

128 See, e.g., Bruce D. Meyer, *Implications of the Illinois Reemployment Bonus Experiments For Theories of Unemployment and Policy Design*, NBER Working Paper No. 2783 (Dec. 1988), <http://www.nber.org/papers/w2783>.

federal funds to pay a percentage of state costs, rather than the full amount, or permitting states to increase funded administrative innovations that reduce benefit costs and induce reemployment.

Workers' Compensation Offers a Viable Model for Unemployment Insurance

Under current federal law, there are severe restrictions to redesigning UI to resemble state **Workers' Compensation** programs.¹²⁹ Such programs pay for an employee's lost income and medical expenses caused by a job-related accident. Not required by federal law, all 50 states nevertheless have set up a workers' compensation program, often as a mandatory alternative to the less predictable and more costly tort lawsuits.

While many states have public funds for workers' compensation, employers in nearly all states can opt to purchase private workers' compensation insurance, self-insure, or group self-insure. The diversity of options has been a success: injury rates have steadily dropped and so has the cost of workers' compensation coverage. The workers' compensation system could be a working model for a wholesale reform of the unemployment insurance system, moving it away from a single-provider model.

At a time when the unemployment insurance system is exhausting its financial reserves, failing at its countercyclical objective, and imposing higher taxes on employers and greater fiscal pressure on the states, and a time when the public is skeptical of extending benefits without broader changes, it may be an opportune moment for significant UI system reform.

Prior to the launch of the federal-state UI program in the 1930s, unemployment benefits were offered by many labor unions and private employers:

Between World War I and 1933, firms such as General Electric, Eastman Kodak, Procter and Gamble, and manufacturer J.I. Case established programs. The latter firm, now Case Corporation, had an employee contribution of 5 percent of earnings—matched by the company—until one year's earnings had been accumulated.

There was also growing interest at the time among insurance companies in introducing UI plans to the public. It is true that private UI would face some economic challenges, particularly the problem of “adverse selection.” Workers at low risk of unemployment would separate themselves from workers with higher risks and form separate insurance pools, or not buy insurance at all.[...] One market response to this situation would be that workers in more cyclical and risky industries would demand higher compensation. Some people would choose to work in industries with higher chances of layoffs, even without any available insurance, if the pay was right. Indeed, economist Price Fishback notes that in the pre-1935 economy, “workers in industries that suffered from layoffs and unemployment generally received higher wages to compensate for this risk.”

Legal restrictions have been a hurdle to the development of private UI. Law Professor Michael Rappaport found, for example, that two Michigan insurers profitably sold UI plans beginning as early as 1910, but state law limited their market to just railroad conductors. Michigan's prohibition on UI insurance was not unique. In the 25 years prior to the enactment of the UI system in 1935, no state clearly authorized the general sale of UI policies. Rappaport looks at the historical evidence and rejects the view that private unemployment insurance wouldn't work.

Consider the experience of Metropolitan Life. The insurance firm's president, Haley Fiske, was adamant that private UI could be sold. However, Fiske “tried to sell UI almost twenty years before the Social Security Act, but the laws of New York State prohibited its sale.” Fiske's effort to legalize UI policies was opposed in the state legislature by Samuel Gompers, who feared that UI plans would strengthen company unions at the expense of his union. Legislation did finally pass the New York legislature, but it was vetoed by Governor Franklin Roosevelt in 1931, who worried that success-

129 Dr. William B. Conerly, *Is Workers' Compensation a Model for Unemployment Insurance?*, National Center for Policy Analysis Brief Analysis (Apr. 2003), <http://www.ncpa.org/pub/ba435>.

ful private UI might undermine support for a government UI system.¹³⁰

Instead of mandating that all employers pay into the federal and state UI funds, Congress could instead let states require that all employers demonstrate ability to provide UI benefits to laid off workers, either through self-funding, purchasing private insurance, setting up savings accounts for workers, or participating in the state fund. This could build on the existing right of certain nonprofit organizations, government agencies, and Indian tribes to self-fund unemployment benefit costs.

Individual Unemployment Benefit Accounts: Design Options

Economist Martin Feldstein proposed the idea of Unemployment Insurance Savings Accounts (UISAs) in 1975. Key features of his proposals have been that each individual (or the individual's employer) would be required to contribute to his or her account, with the mandatory saving stopping when a specified accumulated balance is reached. He has emphasized the goal of "substantially reducing the adverse incentive effects of the existing unemployment insurance system without any decrease in the protection of those who become unemployed."¹³¹ Insurance funds are invested in money markets and earn interest; individuals who exhaust their accounts "can borrow from the government at the same rate as they earn in their account."¹³²

Contributions would be tax-free but withdrawals would be taxable (as UI benefits are today). In a 1998 paper with Daniel Altman, Feldstein laid out five alternative options:¹³³

- **High Saving Base:** Individuals contribute 4 percent of earnings up to a cap of three times the average weekly wage (approx. \$2,637 in 2011). High wage earners would see more rapid accumulation than other earners would.
- **Low Saving Base:** Individuals contribute 4 percent of their earnings up to a cap set at the average weekly wage (approx. \$879 in 2011). This would adjust for the fact that low earners are more likely to rely on UI benefits, so requiring high earners to accumulate savings is less important.

- **Target Account Fund:** Sets a goal of funding an individual's account with 50 percent of their annual income. This would enable the individual, after losing his or her job, to draw out half of their prior wage for up to 12 months.
- **Experience-Based Target Account Fund:** Individuals required to save until the fund reaches (1) 30 percent of their annual wage plus (2) twice the individual's UI withdrawals over the past two years. This ensures that an individual with a history of unemployment will, when employed, be saving higher amounts than other individuals.
- **Experience Rating Component:** Combines Option 2 with a requirement that employers fund the first five weeks of benefits. This would reduce withdrawals for all employees while giving employers an incentive not to create excess unemployment.

Chile implemented an individual account-based unemployment insurance system beginning in 2002. How it works:¹³⁴

- Workers pay 0.6 of their wages into individual accounts, and employers pay a further 1.6 percent of the worker's wages into the account.
- Employers pay a 0.8 percent payroll tax into a "solidarity fund" that pays benefits to new or low-wage workers when their accounts are exhausted.
- Accounts are conservatively invested in a variety of securities by managing funds that also operate the workers' retirement funds.
- After a worker's account has accumulated sufficient funds to pay five months' worth of benefits, no further contributions occur.
- The worker's individual account pays out when the worker becomes unemployed or retires. Unemployed individuals can withdraw 30 to 50 percent of their previous wages each week for up to five months.

Individual accounts would eliminate "excessive search" as unused unemployment funds would add to a worker's retirement income. Workers also own their accounts, enabling them to access the funds immediately on unemployment without extensive processing or claim disputes. Enhanced saving could also help low-income individuals accumulate capital for retirement. The Chilean

¹³⁰ Edwards & Leef, supra note 4.

¹³¹ Martin Feldstein & Daniel Altman, *Unemployment Insurance Savings Accounts*, 21 *Tax Policy and the Economy* 35, 36 (May 2007), <http://www.nber.org/papers/w6860>.

¹³² *Id.* at 41-42.

¹³³ *Id.* at 41-44.

¹³⁴ Dr. William B. Conerly, supra note 126, at 14.

experience found these effects: “We find that for beneficiaries using the [solidarity fund] the pattern of job finding rates over the duration of unemployment is consistent with moral hazard effects, while for beneficiaries relying on UISAs, the pattern is free of such effects.... Our results provide strong support to the idea that UISAs can improve work incentives.”¹³⁵

Congress could permit states to experiment with providing private accounts, or permit them to offer accounts as an option alongside the existing UI system. Elements of the Feldstein approach and the Chile approach could be combined or redesigned as part of a UI reform, to keep features of social insurance and self-insurance.

Conclusion

At a time when the unemployment insurance system is exhausting its financial reserves, failing at its countercyclical objective, and imposing higher taxes on employers and greater fiscal pressure on the states, and a time when the public is skeptical of extending benefits without broader changes, it may be an opportune moment for significant UI system reform. The reforms could be modest, such as eliminating the firewall between administrative costs and benefits, reducing cross-subsidies through

greater use of experience ratings, and relying more on face-to-face training and advising. The reforms could be major, such as adopting elements of state workers’ compensation programs and experimenting with individual accounts to enhance saving.

Key questions must be asked no matter what form the UI system takes. How long should benefits be offered? Should jobless workers be required to take jobs below their education and skill level? Should the long-term unemployed be treated separately? Should the UI system have need-based features? How should benefits be financed when a state exhausts its reserves? At what point should a single employer’s costs be socialized and borne by all employers? Should UI be used as a tool for fiscal stimulus? Should UI benefits be taxed? Who should be ineligible and how should the system be designed to prevent abuse by those not entitled to benefits? What should the taxable base and the tax be and should they change? Should benefit levels and benefit weeks be standardized across states and across industries? How can the system permit innovation while ensuring solvency?

We hope that the facts, analysis, and options provided in these pages contribute to a healthy public debate.



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