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Ignoring Lessons from the Past in Unemployment Insurance Financing:

Proposed legislation would cut benefits for unemployed workers, cut taxes for businesses

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EXECUTIVE SUMMARY

- The combination of tax cuts for employers in the 1990s and two historic downturns in the 2000s has created today's fiscal challenges for the state's unemployment insurance trust fund.
- The proposal to reform the unemployment insurance system presented at the NC General Assembly's Revenue Laws Study Committee appears to be highly out of balance in that it would cut benefits deeply for workers to eliminate the debt and to pay for further tax cuts for employers.
- A conservative estimate of the size of the reduction in taxes is that 43 percent of the state's taxable wages would be taxed at a lower rate if the proposal were enacted. More detailed data could reveal an even greater tax cut on taxable wages and provide information about the number of employers and fiscal impact of those cuts.
- Benefit cuts in the proposal include reduction of the maximum benefit amount by 33 percent, reduction of the maximum duration of benefits from 26 weeks to 20 weeks, changes to the calculation of benefit amounts, and changes in the eligibility rules to reduce the share of unemployed workers that can access benefits.
- Data available on the impact of just the reduction from 26 to 20 weeks on total benefits paid out finds that there would be $166 million less circulating in the economy by the time the system reached solvency in 2016. The economic impact of this loss as measured by economic multipliers could range from the Congressional Budget Office's conservative estimate of $183 million to the estimate of $257 million by Mark Zandi of Moody's Analytics.
- Further analysis and more transparent accounting of the impacts of each aspect of the proposal will be needed to fully determine the impacts on workers, business and the broader economy.

Financing Unemployment Insurance in North Carolina: A Brief History

The unemployment insurance (UI) system was established because of a widespread recognition that the markets were not effective at protecting families from financial ruin in the face of widespread economic downturn, and that businesses and the national economy suffered when many people fell into poverty. Given the interdependence of families' financial well-being and the success of business, the unemployment insurance system was designed to stabilize the economy by providing payments to workers who had lost their jobs through no fault of their own as a way to support their ongoing engagement in economic activity and in turn the recovery process.

Since the 1990s, North Carolina has financed its unemployment insurance system with a pay-as-you-go approach. Instead of raising enough money during good times to pay for the benefits likely to be needed during bad times (known as forward financing), North Carolina cut taxes for businesses during the good times and entered the recession will inadequate reserves. Now deeply in debt to the federal government, the state's UI system is severely weakened.

North Carolina's unemployment insurance trust fund has borrowed $2.5 billion from the federal government in order to pay out benefits to unemployed workers who are seeking work in a labor market that still has three unemployed workers for every job opening. There are more than 34,000 employers who have negative reserve accounts totaling $2.3 billion, which means the benefits paid to the workers they laid off total more than the amount those companies have paid into the system.[1]

The inadequate contributions by employers to the unemployment insurance trust fund, the state-level funding mechanism for unemployment insurance benefits, is due to a series of tax cuts passed in the 1990s (**see Figure 1**). These tax cuts reduced the contributions by employers to the trust fund, leading to a balance that was below minimum safe levels as agreed upon by mainstream economists.[2] The sheer scope of the Great Recession and the historic job loss that resulted further contributed to the system's challenges in the current period.

FIGURE 1: NC Unemployment Insurance Tax Changes, 1992-2000

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

SOURCE: NC Employment Security Commission

Current Proposal to Overhaul the Unemployment Insurance System

On December 5th, members of the Revenue Laws Study Committee of the North Carolina General Assembly unveiled a proposal to overhaul the state's unemployment insurance system through a series of benefit and tax changes that would be implemented beginning July 1, 2013 if legislated during the upcoming session. The proposal was presented as necessary for paying off the state's debt, ensuring businesses can create jobs, and fixing the unemployment insurance system for the future. Additionally, the proposal's sponsors called it a shared sacrifice for businesses and jobless North Carolinians alike.

The Budget & Tax Center's analysis of the proposal finds that, despite small tax increases for employers at the top and bottom of the rate schedule, many employers would see a tax cut. These tax cuts and the existing debt would be paid off through large and permanent cuts to benefits and eligibility for unemployed workers. These cuts would undermine the system's wage replacement function and its ability to support businesses and the economy today and in future downturns.

The proposal fails to establish forward financing and cuts taxes for business owners again, essentially replicating the decisions of the 1990s that heavily contributed to the current crisis. Forward financing along with adequate unemployment benefits are important to ensuring the UI system can play its counter-cyclical role—collecting sufficient contributions in good times so it can pay out benefits that support families and the economy in bad times.

Tax Cuts for Business Paid for with Benefit Reductions

There are several tax changes proposed in the current draft legislation being considered by the Revenue Laws Committee. These changes include the following:

- Requiring governmental entities to maintain a reserve of 1 percent of taxable wages and requiring both governmental and nonprofit entities to pay a 20-percent surcharge
- Increasing the minimum and maximum state unemployment tax rates by 0.06 percent
- Using a formula rather than a series of tax schedules and tables to determine the tax rates that employers pay

Taken together these tax changes represent modest overall reforms to the way the system is financed. They do not adopt financing changes that are generally agreed upon as best practice and have been adopted by other states, like Colorado, seeking to fix their unemployment insurance system to achieve adequacy and stability.[3]

The increase in the minimum and maximum state unemployment tax rates by 0.06 percent would impact 30 percent of private employers. While these increases represent an improvement towards full and equitable participation, they are insufficient to make a significant revenue contribution or align North Carolina more closely with other states.

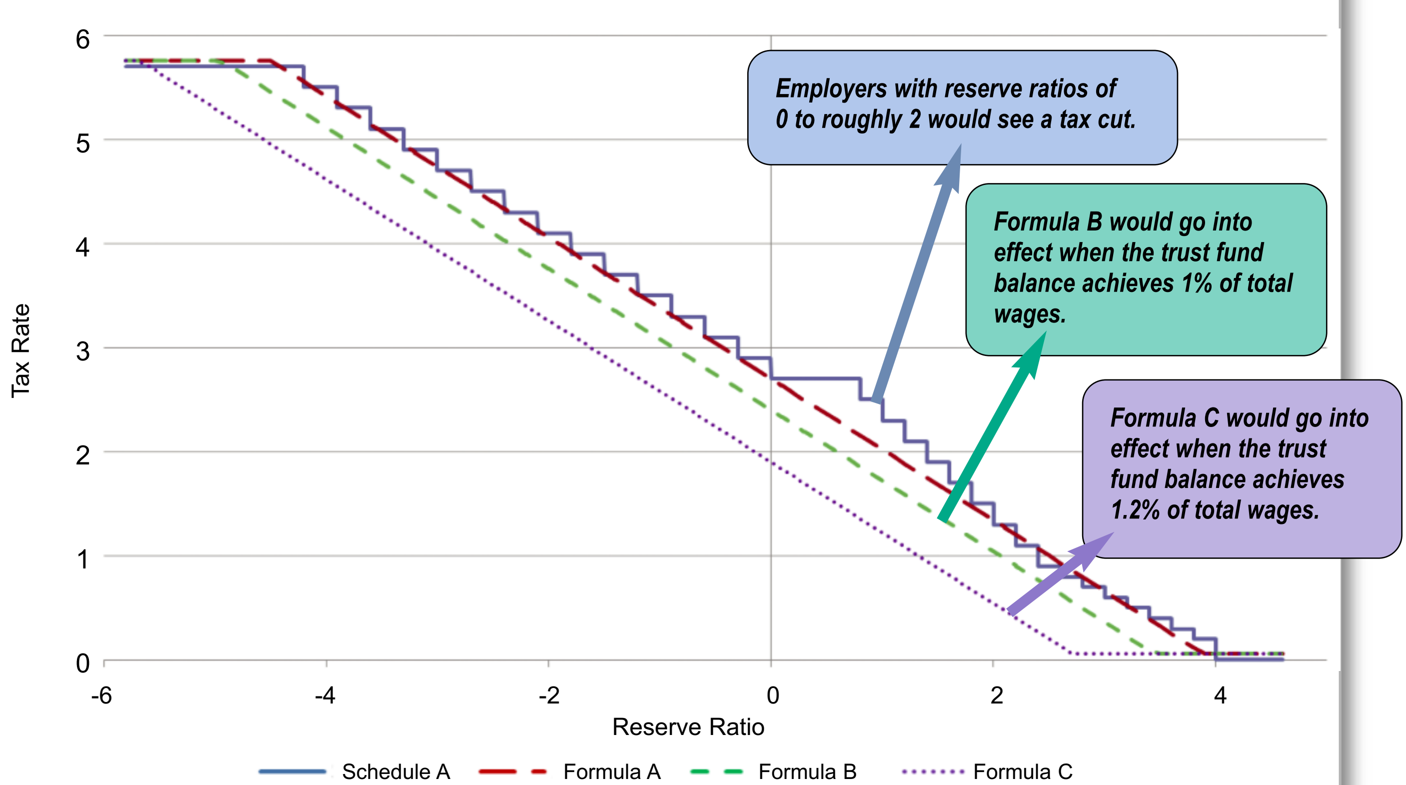
The increase of the minimum tax rate by 0.06 percent would generate about $600,000 in additional collections over the existing zero-percent tax rate. The increase of the maximum tax rate by 0.06 percent to 5.76 percent would generate an estimated $27 million in additional contributions from employers.[4] Taken together, these additional contributions by employers represent 1.1 percent of the trust fund debt. Additionally, 19 states have minimum tax rates greater than zero percent, while 35 states have maximum tax rates higher than the proposed 5.76-percent maximum rate.[5]

Perhaps the most important aspect of the tax changes, however, is the shift from a series of tax schedules to a formula approach. The shift to a formula based on an algebraic expression would smooth the transition between tax levels for employers when contrasted with the current stepped function of the tax schedule. The formula approach would more tightly align the rate an employer pays with the layoffs that employer makes, achieving greater equity for employers.[6] A shift to using formulas rather than tax schedules would also mean that tax rates on employers would change year to year based on small changes in their payroll, for example. The establishment of the applicable tax rate would continue to be based on the employer's credit reserve ratio or reserve ratio, which is a measure of the contributions an employer has made to its account divided by its total taxable payroll over a previous three-year period.

The particular formula options proposed in the Revenue Laws draft legislation likely would worsen the state's already troubled financing of the unemployment insurance system by cutting taxes further for many employers. While the availability of data and the need for more sophisticated models restrict a more complete and definitive analysis, the move to the highest formula (Formula A) being proposed clearly reduces taxes at least for those employers with reserve ratios between 0 and 2. Available data on the distribution of taxable wages demonstrates that at least 43 percent of taxable wages would be taxed at a lower rate under this option than under the current tax schedule.[7] This would impact employer contributions to the trust fund immediately.

Moreover, future tax cuts by a formula shift from Formula A to Formula C could occur

FIGURE 2: Proposed North Carolina Tax Formulas



SOURCE: W.E. Upjohn Institute analysis presented at Revenue Laws Committee on December 5, 2012.

THE IMPACT OF BENEFIT CHANGES

Workers who have lost their jobs through no fault of their own would see their eligibility for benefits, the duration of their benefits, and the amount of their benefits diminished under the Revenue Laws proposal, impacting the financial security of households and the broader economy.

Reduction in Maximum Benefit Amount: A worker who would qualify for the maximum benefit amount under the current formula would see his weekly benefit payments reduced by $175. If that worker were out of work for the average duration of unemployment, 16 weeks, he would have $2800 less in funds to pay bills and make ends meet. Moreover, the establishment of a maximum benefit amount not tied to average weekly wage would result in the erosion over time of the benefit amount relative to workers' prior wages.

Sliding Scale of Duration of Weeks: The implementation of a sliding scale for minimum weeks would disproportionately impact low-wage workers or those engaged in intermittent work. At today's unemployment rate of 9.3 percent, a worker who qualifies for 12 weeks would receive no benefits.

The sliding scale is based on the state unemployment rate. Therefore, in counties where there is high unemployment, workers would be restricted to the maximum number of weeks available according to the state unemployment rate. For example, if the state unemployment rate dropped to 8 percent, jobless workers in Catawba County, Edgecombe County or Rockingham County, where unemployment rates have been between 1 and 3 percentage points higher than the state average, would still be limited to fewer weeks of benefits, despite the more difficult labor-market conditions in their counties.

Change to the Calculation of Weekly Benefit Amount: The way in which weekly benefit amounts are calculated would change to reflect the last two quarters, rather than the last two high quarters of earnings. This would impact workers who have experienced a decline in earnings or hours worked leading up to their layoffs and likely would bring down the average weekly benefit amount. Currently, North Carolina's average weekly benefit amount is $290, which puts North Carolina in the middle of all states.

Using the most recent two quarters of earnings could also arbitrarily result in different benefit amounts for workers with the same exact base-period earnings. For example, someone with base-period wages of $25,000 who earned 60 percent of those wages in the most recent quarter would be eligible for a weekly benefit of $288. However, if this person happened to earn only 40 percent of base-period wages in the most recent quarter, the benefit amount would fall to $192 per week, even though total earnings would be exactly the same.

Definition of Suitable Work: The proposed legislation would redefine suitable work for someone unemployed for 10 weeks or more as a job paying 120 percent of the worker's unemployment benefit amount. Therefore, a worker receiving the current average weekly benefit of $290 would have to take a job paying $8.70 an hour or be disqualified from unemployment insurance payments. A worker who had earned more than $50,000 and was receiving the maximum benefit amount of $350 would be required to take a job paying $10.50 per hour.

These changes to benefits and others to eligibility would be permanent, while the FUTA credit reduction and temporary surcharge for employers will go away if solvency is achieved in 2016. These changes would pay for a permanent tax cut for employers.

FIGURE 3: The UI Reserve and Recommended Balance

Reserve Requirement	Recommended Trust Fund Balance (2011)
Reserve Ratio of 1.25 percent (proposed legislation)	$1,563,814,138
Average High Cost Multiple of 1.0 (federal recommendation)	$1,951,640,044
Reserve Ratio of 2.0 percent (NELP)	$2,502,102,620
High Cost Multiple of 1.0 (Vroman)	$3,077,586,223

SOURCE: Special calculation by NELP, December 2012, analysis of U.S. Department of Labor, Unemployment Insurance Financial Data Handbook 394, Accessed at: http://workforcesecurity.doleta.gov/unemploy/hb394.asp

Definitions

The **Reserve Ratio** represents a state's trust fund balance as a percentage of total wages paid over the most recent 12-month period.

The **High-Cost Multiple** (HCM) compares the size of past UI benefit payment amounts in a 12-month period to current trust fund balances. This multiple relies on the highest benefit cost rate (benefits as a percentage of wages) a state has ever experienced. An HCM of 1.0 means that a state has enough trust fund reserves to pay benefits for one year at the state's highest-ever benefit cost rate.

The **Average High-Cost Multiple** (AHCM) is similar to the HCM, but uses the three highest calendar-year benefit cost rates over the past 20 years or during the period covering the last three recessions, if longer. The Advisory Council on Unemployment Compensation, a federal advisory panel, recommended in 1995 that states maintain a prerecession AHCM of 1.0.

when the trust fund balance is not at a sufficient level to achieve long-term adequacy.

The Advisory Council on Unemployment Compensation, a nonpartisan federal advisory panel, recommended in 1995 that states maintain enough trust fund reserves to pay UI benefits for one year at a recession-level payout rate (i.e., an Average High Cost Multiple of 1.0). To have met this benchmark at the end of 2011, North Carolina needed a reserve balance of nearly $2.0 billion (see table). Under the proposed legislation, the lowest tax schedule would have gone into place with trust fund reserves of just $1.56 billion. UI financing experts often recommend even higher trust fund balances. For example, Wayne Vroman of the Urban Institute recommends states maintain a High Cost Multiple of 1.0, and the National Employment Law Project recommends a reserve ratio of 2.0 (**see Figure 3 for a comparison of these solvency measures**).

Under the Revenue Laws proposal, the lowest tax schedule would take affect long before the trust fund has adequate reserves as recommended by any of the widely accepted solvency measures.

This preliminary analysis of these proposed financing changes suggests that there will be reductions in the contributions by employers in the immediate and long term if this proposal is implemented. In order to achieve solvency and pay for these tax cuts to employers, significant benefit cuts, as detailed in the sidebar, are being proposed.

The net impact of these benefit changes is not possible to calculate given available data. However, based on a conservative calculation using the Upjohn Institute analysis of just the reduction from 26 to 20 weeks, by the time the trust fund achieves solvency in 2016, total benefit payouts would be $166 million less or 15 percent less than what they would have been if the maximum weeks remained at 26.[8] The impact on the economy of

benefit payments, and thus less spending at businesses, has been estimated to have a multiplier effect of 10 percent by the Congressional Budget Office and 55 percent by Mark Zandi of Moody's Analytics.[9] The decline in benefit payouts by $166 million would result in a decline in economic impact of between $183 million and $257 million.

Conclusion

Further analysis of this proposal is needed to fully assess the impact on workers, business and the economy ahead of policymakers taking a vote. However, it appears from the available data that the draft legislation proposed in the Revenue Laws Study Committee would eliminate the debt and provide employers a tax cut by slashing benefits and eligibility.

It is critical for the public and policymakers to receive detailed information about who would be impacted by each benefit and tax change and who and what would contribute to achieving solvency in the near term. It is also essential that policymakers remain oriented toward a goal of building an unemployment insurance system that can serve the state's economy in future downturns.

1 Special data request to Division of Employment Security, NC Department of Commerce, December 2012.

2 For more on the causes of North Carolina's insolvency, see Sirota, Alexandra, March 2011, The Path to Insolvency: Tax Changes, Great Recession Drive Unemployment Insurance Trust Fund Challenges. BTC Brief, NC Justice Center: Raleigh, NC.

3 NELP, May 2010. Unemployment Insurance Financing in Crisis: How Should States Respond to Trust Fund Insolvency; General Accounting Office, April 2010. Unemployment Insurance Trust Funds: Long-standing State Financing Policies Have Increased Risk of Insolvency; Vroman, Wayne, October 2011. Unemployment Insurance: Problems and Prospects. Unemployment Insurance Brief: National Academy of Social Insurance and Upjohn Institute.

4 Author's calculation based on estimates provided in the W.E. Upjohn Institute, May 2012, North Carolina's Unemployment Insurance System: A Simulation and Policy Analysis.

5 US Department of Labor, 2012, Comparison of State Unemployment Laws, Attached at: http://www.unemploymentinsurance.doleta.gov/unemploy/comparison2012.asp

6 Upjohn Institute, May 2012.

7 Special data request to Division of Employment Security, NC Department of Commerce, December 2012.

8 Author's calculation based on W.E. Upjohn Institute analysis in Tables 5.17.1 and 5.17.7.

9 Congressional Budget Office, November 2012, Unemployment Insurance in the Wake of the Recent Recession. Congress of the United States: Washington, DC and Zandi, Mark, February 2012. Bolstering the Economy: Helping American Families by Reauthorizing the Payroll Tax Cut and UI Benefits.

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