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UNEMPLOYMENT INSURANCE: Comments on
HR. 3896, The Unemployment Compensation
Reform Act of 1990

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

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SUMMARY OF TESTIMONY BY LAWRENCE H. THOMPSON
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ON H.R. 3896
THE UNEMPLOYMENT COMPENSATION REFORM ACT OF 1990

The Unemployment Insurance (UI) system provides income maintenance assistance to the unemployed using federal and state employer taxes. The system is based on a forward funded principle under which reserves are accumulated during economic upturns to pay benefits during periods of declining economic activity. Recent recessions have exhausted the reserves in many state accounts, resulting in state borrowing from federal UI accounts to pay benefits. On occasion, the federal accounts have needed general revenue transfers to cover these loans.

FORWARD FUNDING PRINCIPLE HAS BEEN ERODED Recently, the increased reliance on loans and general fund advances has eroded the forward funding principle. For nine consecutive years, between 1976 and 1984, the UI system operated with a negative net balance. Policy changes by the Congress in the 1980s to foster solvency expedited state loan repayments but resulted in increased UI taxes and reduced access to benefits by the unemployed. Unless the system becomes forward funded, such a result can again be expected if the system needs significant loans during future recessions.

CURRENT RESERVES APPEAR INADEQUATE Even though trust fund reserves have increased substantially in recent years, they still appear to be inadequate to handle a severe recession. Using a Labor Department model to simulate the impact of a severe recession beginning in 1991, GAO estimates that the system would once again require loans and general fund advances to pay benefits.

EFFECTS OF INCREASING THE TAXABLE WAGE BASE An increase in the taxable wage base is a step in the right direction toward restoring the forward funding nature of the program. Such a measure would generate increased revenue for the federal trust fund accounts, likely eliminating the need for future general fund advances similar to those that accompanied recessions in the past 20 years. It would also increase state reserves, but probably not enough to avoid federal borrowing in the event of a severe recession.

FUNDING FOR STATE ADMINISTRATION While state administration of the UI program was intended to be federally funded, a prior GAO report pointed out that states had increased their reliance on their own funds to supplement federal allocations. Without changes to the state administrative funding mechanism, future recessions could affect the states' ability to provide benefits to the unemployed in a timely and accurate manner. H.R. 3896 would provide the states with $3 billion annually for administrative costs. GAO is uncertain as to whether this is the right amount and mechanism for funding administration, but endorses further exploration of this matter.

Mr. Chairman and Members of the Subcommittee:

We are pleased to be here today to assist you in your deliberations on H.R. 3896, the Unemployment Compensation Reform Act of 1990. While the bill contains several key provisions to revise the unemployment compensation system, my testimony will focus primarily on the proposal to increase the federal unemployment taxable wage base. This proposal will increase the taxable wage base from the current level of $7,000 to $10,000, in annual increments of $1,000, and then index it to the growth in average annual covered wages thereafter. In addition, I will have some brief comments relating to the provision to reform state administrative financing.

Before elaborating on these provisions, I would like to provide some background on the characteristics of the Unemployment Insurance (UI) system.

BACKGROUND

The UI system is the federal government's major means of providing income maintenance assistance to the unemployed. The system's primary objectives are first, to provide individuals with temporary and partial wage replacement when they have lost their jobs, and second, to assist in the countercyclical stabilization of the national economy during economic downturns by maintaining workers' purchasing power. The UI system is operated as a partnership between the federal government and the states. The federal government levies a payroll tax on employers to finance state and federal UI program administration, one-half of an extended benefits program, and loans to states with insolvent UI accounts. Each state operates its own UI program, levying and collecting its own payroll tax and, within certain limits, determining the level of benefits and the conditions for benefit eligibility. As a result, tax rates, benefit levels, and trust fund balances vary across states, reflecting variations in program decisions and economic conditions.

The gross federal tax rate is 6.2 percent on the first \$7,000 paid in wages annually to each employee. However, if a state meets certain federal requirements and has no delinquent federal loans, its employers are eligible for up to a 5.4 percent credit, making the net federal tax rate 0.8 percent. To receive the maximum federal tax credit of 5.4 percent, states must establish a taxable wage base for state UI taxes at least equal to the Federal taxable wage base--currently \$7,000. All states have done this, and 36 states have adopted wage bases above the federally mandated level, ranging from \$7,100 in Connecticut to \$20,900 in Alaska.

Currently, the net federal tax rate of 0.8 percent is made up of a permanent tax rate of 0.6 percent and a temporary surtax of 0.2 percent. The surtax was added in 1976 to help the system repay loans from the federal general fund. The surtax was extended in 1987 and is due to expire at the end of 1990.