

**GAO**

Testimony

Before the Subcommittee on Income  
Security and Family Support, Committee  
on Ways and Means, House of  
Representatives

---

For Release on Delivery  
Expected at 10:00 a.m. EDT  
Thursday, May 6, 2010

**UNEMPLOYMENT  
INSURANCE TRUST  
FUNDS**

**Long-standing State  
Financing Policies Have  
Increased Risk of  
Insolvency**

Statement of Andrew Sherrill, Director  
Education, Workforce, and Income Security



**GAO**

Accountability \* Integrity \* Reliability

---

---

Mr. Chairman and Members of the Subcommittee:

I am pleased to be here today as you examine issues related to the financial condition of state unemployment insurance (UI) programs. This has been a topic of concern for the last 3 decades and has generated multiple studies, including several by GAO. The severity and length of the recent recession have resulted in the worst labor market conditions in the United States since at least the early 1980s, if not since the Great Depression of the 1930s, and placed a heavy demand on state UI trust funds. While preliminary data showed that the economy added the most jobs in any month in 3 years during March 2010, unemployment remains very high and has continued to increase in most states, suggesting that state UI programs will continue to face serious financial challenges for at least the near future. My remarks today are based on our report, released at this hearing, *Unemployment Insurance Trust Funds: Long-standing State Financing Policies Have Increased Risk of Insolvency*.<sup>1</sup>

The federal-state UI program provides temporary, partial compensation for lost earnings of individuals who become unemployed, with the additional goal of stabilizing the economy during economic downturns. The program was designed to be forward funded and self-financed by states, with each state trust fund building up reserves from employer taxes during periods of economic expansion in order to pay UI benefits during economic downturns.<sup>2</sup> The program is financed primarily by taxes levied on employers.<sup>3</sup> Each state sets UI tax rates to finance regular UI benefits. In addition, employers pay a Federal Unemployment Tax Act (FUTA) tax, which is used for UI administration costs and other purposes. The FUTA tax on employers is 6.2 percent on the first \$7,000 of each employee's annual pay.<sup>4</sup> Employers in states whose UI programs comply with federal requirements receive a tax rate credit of 5.4 percent, resulting in an

---

<sup>1</sup>GAO-10-440 (Washington, D.C.: April 2010).

<sup>2</sup>The term "forward funding" usually refers to budget authority that is made available for obligation beginning in the last quarter of the fiscal year for the financing of ongoing activities (usually grant programs) during the next fiscal year. GAO, *A Glossary of Terms Used in the Federal Budget Process*, GAO-05-734SP (September 2005). However, in this testimony we use the term to refer to the practice of states accumulating reserves in unemployment insurance trust funds in anticipation of increased outlays in the future.

<sup>3</sup>Alaska, New Jersey, and Pennsylvania also withhold UI taxes from employee wages.

<sup>4</sup>26 U.S.C. § 3301.

---

effective rate as low as 0.8 percent, or a maximum of \$56 per worker per year.<sup>5</sup>

States choose both a taxable wage base, the annual earnings per worker on which employers pay UI taxes, and statutory tax rates that apply to the base. In order for employers in their state to qualify for the full FUTA tax credit, each state's taxable wage base must at least equal the FUTA wage base and statutory rates must be experience rated—that is, varying with an employer's layoff record. Experience ratings provide reduced rates for employers with fewer layoffs and increased rates for those with more layoffs. Tax rate assignment may include “socialized” costs that are not charged to individual employers, such as costs of benefits to employees of firms that went out of business but did not have sufficient reserves to pay UI taxes or benefits that are charged to a specific employer but are not fully recovered from that firm in tax revenue. The Unemployment Insurance Trust Fund (UTF) in the U.S. Treasury consists of 53 state accounts, including one each for the District of Columbia, the Virgin Islands, and Puerto Rico, plus 6 federal accounts that are dedicated for special purposes.

During exceptional periods when states exhaust their UI reserves, they may borrow from the federal government. States can, under certain conditions, borrow interest free, as long as the loan is repaid by September 30 of the year of the loan (a “cash flow” loan).<sup>6</sup> If a state has an outstanding loan balance on January 1 for 2 consecutive years, the full amount of the loan must be repaid by November 10 of the second year, or employers in that state lose 0.3 percent of the FUTA tax credit each year there is an unpaid balance. However, states with outstanding loans can still seek relief from these loan provisions. If state trust funds meet specific requirements, such as not taking any action during the previous year that would diminish the solvency of their trust fund, the reduction in

---

<sup>5</sup>26 U.S.C. § 3302.

<sup>6</sup>42 U.S.C. § 1322(b)(2). In addition to repaying a loan by September 30 the state may not have another advance during the calendar year and must meet funding goals established under regulations issued by the Secretary of Labor. The requirement that Labor establish funding goals was added by the Balanced Budget Act of 1997 (Pub. L. No. 105-33, § 5404). Labor has published proposed rules on funding goals which have yet to be finalized. See 74 Fed. Reg. 30,402 (June 25, 2009). ARRA provided that all loans from the federal government are interest-free until December 31, 2010, 42 U.S.C. § 1322(b)(10) (as added by Pub. L. No. 111-5, Div. B, § 2004).

---

the FUTA credit may be capped.<sup>7</sup> States that have an average total unemployment rate of 13.5 percent or more<sup>8</sup> can also delay payment of interest for a grace period of up to 9 months.<sup>9</sup>

In light of concerns about the ability of state UI trust funds to pay benefits, our report discusses (1) the current condition of state UI trust funds; (2) policies and practices that have contributed to their condition; and (3) options for improving UI forward funding in the future. To address these issues, we analyzed UI statistical data from the Department of Labor's (DOL) Employment and Training Administration (ETA). We also examined applicable federal and state laws, regulations, and guidance; reviewed reports by government agencies, including those from past government advisory councils on unemployment compensation, and public policy organizations; and conducted interviews with Labor officials and UI policy experts from the business, labor, academic, and public policy communities. We conducted our performance audit from May 2009 through April 2010 in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

In summary, we found that state UI trust funds are in historically poor financial condition. As of April 1, 2010, 34 of the 53 state trust funds have outstanding loans totaling \$38.9 billion from the federal government to pay benefits (see fig. 1). Aggregate reserves net of loans measured -\$15.4 billion as of the end of 2009, the lowest level in the program's history. Despite UI tax rates that are expected to rise significantly in many states in 2010, the Department of Labor projects that net UI reserves will remain negative for several years.

---

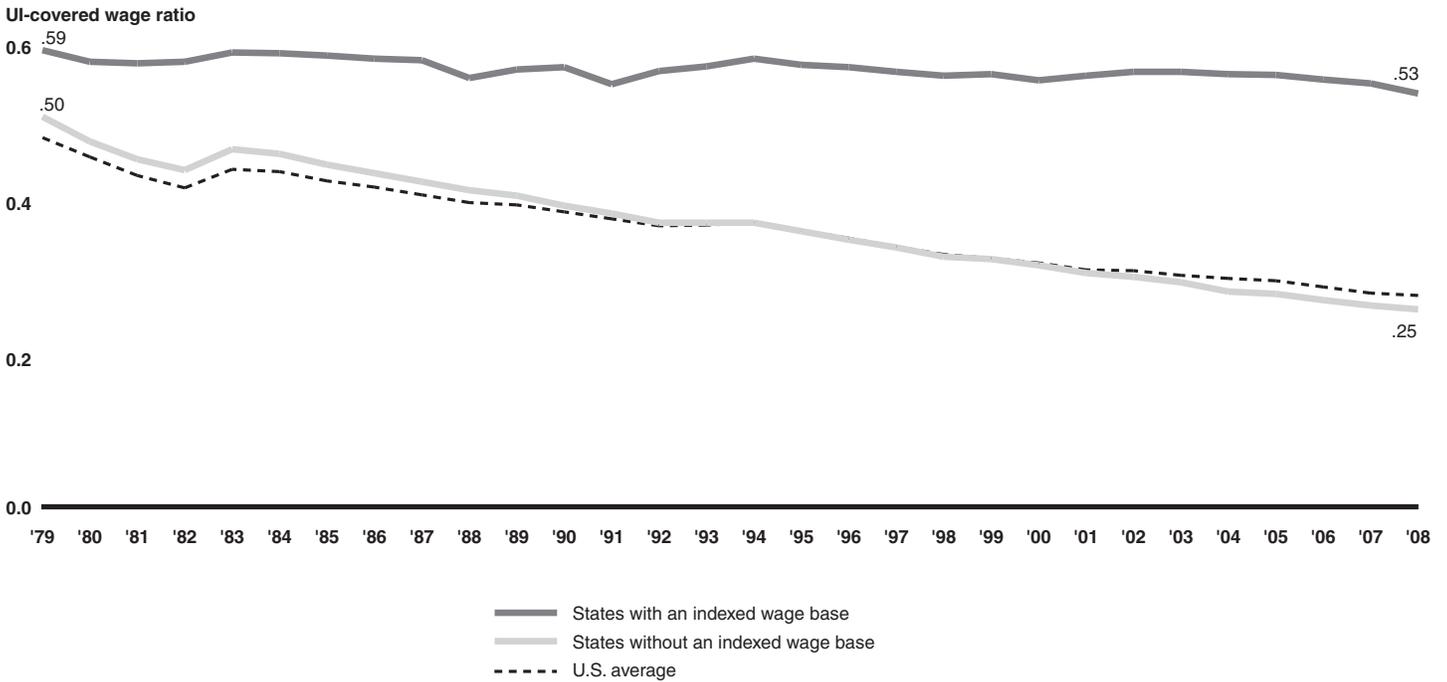
<sup>7</sup>See 26 U.S.C. § 3302(f).

<sup>8</sup>This rate of 13.5 percent or greater is for the most recent 12-month period for which data are available.

<sup>9</sup>42 U.S.C. § 1322(b)(9).



**Figure 2: Comparison of UI-taxable/total Wage Ratio, States with Indexed Taxable Wage Bases vs. Other States, 1979-2008**



Source: GAO calculations based on data from Unemployment Insurance Financial Data Handbook; Employment and Training Administration, Department of Labor.

Note: The UI-taxable/total wage ratio divides the portion of total wages among employees in UI-covered employment each state subjects to UI taxation by the total wages earned by these employees. Some states have indexed their UI taxable wage bases for only some years during 1979-2008. We categorize Virgin Islands as indexing from 2004-8; Rhode Island from 1980-1998; Wyoming from 1984-2008; Oklahoma from 1986-2008; and North Carolina from 1984-2008. States that indexed their wage bases for the entire period are Alaska, Hawaii, Idaho, Iowa, Minnesota, Montana, Nevada, New Jersey, New Mexico, North Dakota, Oregon, Utah, and Washington.

Options to improve state UI trust fund financial conditions include raising and indexing the FUTA taxable wage base, which has remained at \$7,000 per worker per year since 1983. This could induce many states to raise and index their own taxable wage bases. In addition, state UI tax reform could reduce the number of employers paying very low rates and those that pay less in UI taxes than benefits paid to their former workers. Other options include adjusting state tax rates more frequently; raising solvency targets before lowering rates; setting additional conditions to receive interest-free federal loans; and raising interest credits for well funded trust funds (see table 1).

**Table 1: Policy Options for Improving UI Funding**

<b>Policy</b>	<b>Who could implement</b>	<b>Advantages</b>	<b>Disadvantages</b>
Raise and index FUTA taxable wage base	Congress	<p>Would reverse years of erosion of UI tax base and maintain wage base as a consistent proportion of income.</p> <p>Would cause states to raise their taxable wage bases to qualify for FUTA credit.</p> <p>Could allow federal government and states to reduce statutory tax rates for given UI funding goals.</p>	<p>Higher UI taxes could discourage hiring.</p> <p>Federal taxable wage base represents different tax burdens to different states.</p> <p>Resistance of states to increasing burden on employers to pay more to federal trust funds.</p>
Reduce number of employers paying very low UI tax rates	States <sup>a</sup>	<p>Would increase UI contributions.</p> <p>Would better distribute costs of social insurance.</p>	<p>Fairness—UI taxes may not reflect costs attributable to employers.</p> <p>Would reduce incentive for employers to avoid layoffs.</p>
Reduce large tax subsidies across employers and industries	States <sup>a</sup>	<p>Distribution of UI taxes based on costs created by employer layoffs.</p> <p>Stronger incentives for employers to avoid layoffs.</p>	<p>Increased rates may encourage employers with high tax rates to try to circumvent tax.</p>
Adjust state tax rates more frequently than annually and raise solvency targets before implementing lower tax rates	States <sup>a</sup>	<p>Tax rates could adjust before trust fund becomes severely depleted.</p> <p>More funds raised during strong, not weak, economic conditions.</p>	<p>Higher administrative costs.</p> <p>Less ability of employers to anticipate tax rates.</p> <p>Resistance from employers to paying relatively high UI taxes when trust funds were flush.</p>
Set additional conditions on interest-free loans	Department of Labor <sup>b</sup>	<p>Strengthen incentives for states to avoid loans with more robust forward funding.</p>	<p>Increased reliance on higher tax rates during difficult economic times.</p> <p>Estimated small impact.</p> <p>State objections to paying more for funds their taxes provide.</p>
Offer increased interest credits to state trust funds funded above a certain level	Congress	<p>Incentive for states to save more in trust funds.</p>	<p>States with lower funding balances may receive less in interest.</p>

Source: GAO analysis based on findings.

<sup>a</sup>While only states could implement these policy changes, Congress could include these as requirements for employers in a state to qualify for the FUTA tax credit.

<sup>b</sup>Labor has published proposed rules on interest-free loan conditions that have yet to be finalized.

In conclusion, the long-term decline of UI funding, culminating in widespread borrowing by state trust funds and the dire financial condition of the program, raises critical questions about the ability of the program to function as it has in the past. The program is designed to allow states significant latitude in deciding how much to tax their employers and pay in benefits. However, any increased borrowing could change the nature of

---

the program's federal-state partnership, with the federal government taking on more chronic funding responsibility for paying benefits rather than providing, as originally envisioned, a backstop to states when they experience financial emergencies. In addition weakening forward funding could put pressure on states to reduce benefits, which might compromise the program's goal of providing macroeconomic stability during recessions. Now is the time, therefore, to consider changes to federal program policies that could better assure the long-term financial structure of UI trust funds.

Our report included a matter for Congressional consideration regarding the possibility of raising the FUTA taxable wage base from its current level of \$7,000 and indexing this base to average annual wages. At the same time, we suggested that Congress should consider measures to ameliorate the potential increase in the tax burden on employers, such as lowering the FUTA statutory tax rate or increasing the FUTA tax credit.

The Department of Labor provided written and technical comments on a draft of our report. Labor generally agreed with the findings and conclusions of the report. Labor's written comments are included in our report.

Mr. Chairman, this concludes my prepared remarks. I would be happy to answer any questions that you or the other Members of the Subcommittee may have.

For future contact regarding this statement, please contact Andrew Sherrill at (202) 512-7215 or at [sherrilla@gao.gov](mailto:sherrilla@gao.gov). Contact points for our Offices of Congressional Relations and Public Affairs may be found on the last page of this statement. Michael J. Collins, Assistant Director; Mark M. Glickman; and Kristy Kennedy also made key contributions to this statement.

---

# Related GAO Products

---

*Employee Misclassification: Improved Coordination, Outreach, and Targeting Could Better Ensure Detection and Prevention.* [GAO-09-717](#). Washington, D.C.: August 10, 2009.

*Unemployment Insurance: More Guidance and Evaluation of Worker-Profiling Initiative Could Help Improve State Efforts.* [GAO-07-680](#). Washington, D.C.: June 14, 2007.

*Human Service Programs: Demonstration Projects Could Identify Ways to Simplify Policies and Facilitate Technology Enhancements to Reduce Administrative Costs.* [GAO-06-942](#). Washington, D.C.: Sept. 19, 2006.

*Unemployment Insurance: States' Tax Financing Systems Allow Costs to Be Shared among Industries.* [GAO-06-769](#). Washington, D.C.: July 26, 2006.

*Unemployment Insurance: Enhancing Program Performance by Focusing on Improper Payments and Reemployment Services.* [GAO-06-696T](#). Washington, D.C.: May 4, 2006.

*Unemployment Insurance: Factors Associated with Benefit Receipt and Linkages with Reemployment Services for Claimants.* [GAO-06-484T](#). Washington, D.C.: March 15, 2006.

*Unemployment Insurance: Factors Associated with Benefit Receipt.* [GAO-06-341](#). Washington, D.C.: March 7, 2006.

*Unemployment Insurance: Better Data Needed to Assess Reemployment Services to Claimants.* [GAO-05-413](#). Washington, D.C.: June 24, 2005.

*Unemployment Insurance: Survey of State Administrators and Contacts with Companies Promoting Tax Avoidance Practices.* [GAO-03-819T](#). Washington, D.C.: June 19, 2003.

*Unemployment Insurance: States' Use of the 2002 Reed Act Distribution.* [GAO-03-496](#). Washington, D.C.: March 6, 2003.

*Unemployment Insurance: Increased Focus on Program Integrity Could Reduce Billions in Overpayments.* [GAO-02-697](#). Washington, D.C.: July 12, 2002.

*Unemployment Insurance: Role as Safety Net for Low-Wage Workers Is Limited* [GAO-01-181](#). Washington, D.C.: December 29, 2000.

---

*Unemployment Insurance: Program's Ability to Meet Objectives Jeopardized.* [GAO/HRD-93-107](#). Washington, D.C.: September 28, 1993.

*Unemployment Insurance: Trust Fund Reserves Inadequate to Meet Recession Needs.* [GAO/HRD-90-124](#). Washington, D.C.: May 31, 1990.

*Unemployment Insurance: Trust Fund Reserves Inadequate.* [GAO/HRD-88-55](#). Washington, D.C.: September 26, 1988.

---

---

This is a work of the U.S. government and is not subject to copyright protection in the United States. The published product may be reproduced and distributed in its entirety without further permission from GAO. However, because this work may contain copyrighted images or other material, permission from the copyright holder may be necessary if you wish to reproduce this material separately.

---

## GAO's Mission

The Government Accountability Office, the audit, evaluation, and investigative arm of Congress, exists to support Congress in meeting its constitutional responsibilities and to help improve the performance and accountability of the federal government for the American people. GAO examines the use of public funds; evaluates federal programs and policies; and provides analyses, recommendations, and other assistance to help Congress make informed oversight, policy, and funding decisions. GAO's commitment to good government is reflected in its core values of accountability, integrity, and reliability.

---

## Obtaining Copies of GAO Reports and Testimony

The fastest and easiest way to obtain copies of GAO documents at no cost is through GAO's Web site ([www.gao.gov](http://www.gao.gov)). Each weekday afternoon, GAO posts on its Web site newly released reports, testimony, and correspondence. To have GAO e-mail you a list of newly posted products, go to [www.gao.gov](http://www.gao.gov) and select "E-mail Updates."

---

## Order by Phone

The price of each GAO publication reflects GAO's actual cost of production and distribution and depends on the number of pages in the publication and whether the publication is printed in color or black and white. Pricing and ordering information is posted on GAO's Web site, <http://www.gao.gov/ordering.htm>.

Place orders by calling (202) 512-6000, toll free (866) 801-7077, or TDD (202) 512-2537.

Orders may be paid for using American Express, Discover Card, MasterCard, Visa, check, or money order. Call for additional information.

---

## To Report Fraud, Waste, and Abuse in Federal Programs

Contact:

Web site: [www.gao.gov/fraudnet/fraudnet.htm](http://www.gao.gov/fraudnet/fraudnet.htm)

E-mail: [fraudnet@gao.gov](mailto:fraudnet@gao.gov)

Automated answering system: (800) 424-5454 or (202) 512-7470

---

## Congressional Relations

Ralph Dawn, Managing Director, [dawnr@gao.gov](mailto:dawnr@gao.gov), (202) 512-4400  
U.S. Government Accountability Office, 441 G Street NW, Room 7125  
Washington, DC 20548

---

## Public Affairs

Chuck Young, Managing Director, [youngc1@gao.gov](mailto:youngc1@gao.gov), (202) 512-4800  
U.S. Government Accountability Office, 441 G Street NW, Room 7149  
Washington, DC 20548

