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UNEMPLOYMENT INSURANCE:

Issues Relating to Reserve Adequacy and Trust Fund Solvency

Statement of
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Before the
Subcommittee on Public Assistance
and Unemployment Compensation
Committee on Ways and Means
House of Representatives

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SUMMARY OF GAO TESTIMONY BY WILLIAM J. GAINER ON UNEMPLOYMENT INSURANCE — ISSUES RELATING TO RESERVE ADEQUACY AND TRUST FUND SOLVENCY

The Unemployment Insurance (UI) system is the federal government's major means of providing income maintenance assistance to the unemployed. The aggregate Unemployment Insurance system and the vast majority of individual state trust funds do not have adequate reserves; they are insufficient to pay recession-level benefits in an economic downturn without massive federal borrowing.

INADEQUATE RESERVES. Since the mid-1970's the UI system has faced an increasing problem of insolvency, with 31 trust funds needing to borrow more than $26 billion from the federal government to continue paying benefits to the unemployed. Currently 7 states are insolvent. While the system has $15.4 billion in reserves, most states' reserves are inadequate and will likely need billions of dollars in federal loans to pay benefits during the next recession. Current reserves are equivalent to only 5 months of recession-level benefit payments, less than the 12 months which recent recessions have lasted.

RESERVE FORECASTS. Econometric forecasts suggest that reserve adequacy will not improve even if current economic growth continues into the 1990's. In addition, these forecasts predict that a moderate recession in 1988 would more than double the number of insolvent state trust funds from 7 to 17.

FEDERAL POLICY CHANGES. A variety of federal policies enacted during the 1980's have increased the costs of insolvency to state programs. These policies have likely encouraged some states to avoid insolvency, but have not resulted in the accumulation of reserves sufficient to pay benefits during a recession without federal loans. In addition to raising UI taxes, many states have also reduced benefit costs by reducing the duration of benefits, or tightening eligibility standards. These actions have contributed to a reduction in the proportion of the unemployed receiving benefits which, at less than a third of the unemployed in the 1980's, is the lowest sustained level ever. Future recessions will likely repeat the pattern of the early 1980's, with states needing large federal loans to pay benefits and again reducing the proportion of workers receiving benefits in an effort to reduce costs and regain solvency.

CONCLUSION. The UI system is currently operating in a way which fails to encourage states to build adequate reserves to withstand future recessions. Congress should take action to improve the adequacy of trust fund reserves to minimize the prevalence of trust fund insolvency during economic downturns and thus avoid the need for multi-billion dollar federal borrowing. Congress also needs to be mindful to maintain appropriate levels of worker benefits.

Mr. Chairman and Members of the Subcommittee:

I am pleased to be here today to share with you some preliminary results from GAO's analysis of major issues facing the federal-state Unemployment Insurance (UI) system. In particular, I will discuss the increasing incidence of trust fund insolvency -- meaning states exhaust their trust fund reserves and must obtain federal loans to pay benefits to unemployed workers-- and the declining adequacy of UI trust fund reserves --adequacy meaning that states have reserves sufficient to pay benefits during economic downturns without becoming insolvent. We have analyzed trends in trust fund reserve balances and recipiency coverage, the causes of these trends and the projected impact on trust fund reserves of future recessions. Our major conclusions are as follows:

- Since the mid-1970's the overall national system has faced an increasing problem of trust fund insolvency. States have needed billions of dollars in federal loans to continue paying benefits to the unemployed.

- Many state UI trust funds are not currently maintaining reserves sufficient to pay benefits during the next recession without multi-billion dollar borrowing from the federal government.

- If a moderate recession occurred in 1988, the number of insolvent trust funds would likely more than double from 7 to 17.

- Even if the current economic expansion continues into the 1990's, trust fund reserves are expected to remain inadequate.

- A variety of federal policies, such as charging interest on federal loans to states and employer penalty taxes, have increased the costs of insolvency to state programs. These policies have likely encouraged some states to avoid short term insolvency, but have not resulted in the accumulation of adequate reserves. However, they have caused states to reduce benefit costs by reducing the duration of benefits and tightening eligibility standards, thereby contributing to the decline in the proportion of the unemployed receiving benefits.

Unless states change their funding practices, future recessions will likely exacerbate the pattern of the early 1980's with states needing large federal loans to pay benefits and, in an effort to regain solvency, states again reducing the proportion of workers receiving benefits. This proportion has declined from nearly one half during the 1950's, to less than a third in the

1980's, and in October of this year, only 26 percent of the unemployed received benefits.

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 to provide employees with temporary and partial insurance against income loss resulting from unemployment and to assist in the counter-cyclical stabilization of the national economy during economic downturns. In 1986, the trust funds of the 50 states, the District of Columbia, Puerto Rico and the Virgin Islands paid about $16.4 billion to more than 8.5 million unemployed workers and collected about $22 billion in employer taxes and interest.

ADEQUACY OF TRUST FUND RESERVES

To determine whether state trust fund reserves are being maintained at levels sufficient to pay benefits during times of increased unemployment, GAO examined trends in the most commonly used measure of financial adequacy, known as the "High Cost Multiple" which compares current reserves to peak historic benefit payouts. (See table 1) In the past, the Department of Labor recommended that states voluntarily adopt a standard for the high cost multiple of 1.5, and state employment security agency administrators also sanctioned a 1.5 multiple as indicative of reserve adequacy. Although the arithmatic is somewhat complicated, this standard is equivalent to requiring that reserves be available sufficient to pay recession-level benefits for one and a half years. GAO found that in 1986 the aggregate High Cost Multiple for state funds was only .44 -- meaning that reserves on average were sufficient to pay benefits for only about 5 months, which is much shorter than recent recessions that have averaged about 12 months.

As for individual trust funds, 39 states had adequate trust fund reserves in 1969 (meeting the 1.5 standard), but only 2 states had adequate reserves in 1975 (See figure 1). As of 1986, only Mississippi and South Dakota had funds considered to be adquate. Although a standard of 1.5 is now considered by some to be too conservative, even if a more lenient 1.0 standard is used, current reserves are still inadequate. Using the 1.0 standard, only 11 state funds were found to have adequate reserves in 1986, down from 51 in 1969. Thus, while only 8 states were insolvent in 1986, 34 solvent states were maintaining inadequate levels of trust fund reserves using the 1.0 standard.

Table 1 -- ADEQUACY OF TRUST FUND RESERVES

o States Need to Maintain Reserves Sufficient to Pay Benefits During Recessions

o Current Reserves are Insufficient

  - Funds' Ability to Pay Recession-level Benefits Have Declined

  - In 1986 Reserves Were Equivalent to 5 Months of Recession-level Benefits

  - Recessions Average 12 Months

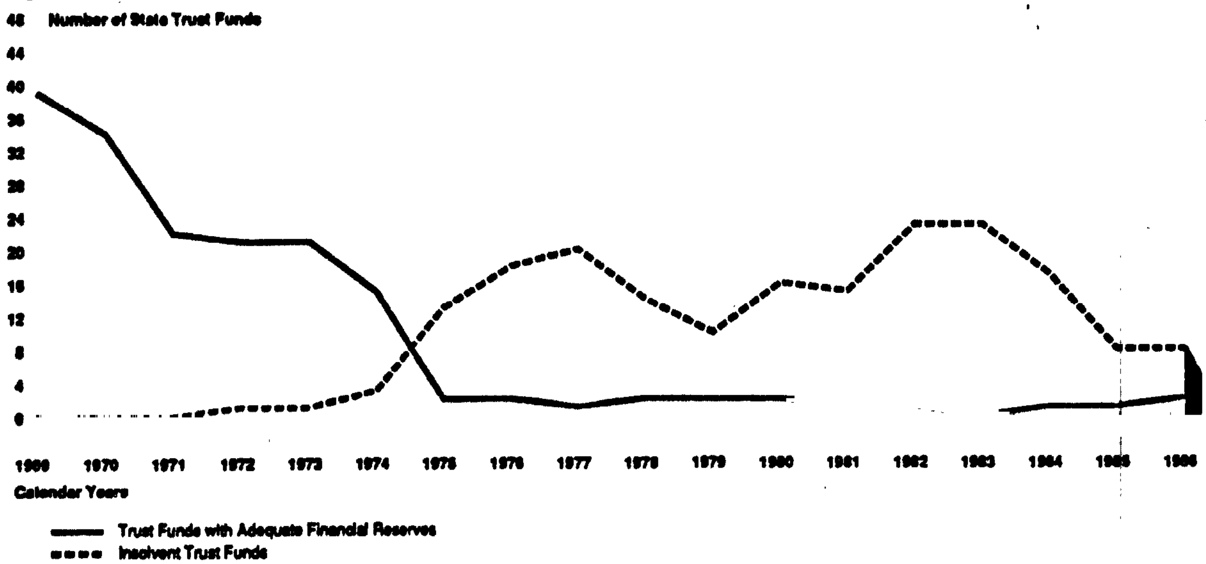
o Inadequate Reserves Have Resulted in Large Federal Loans to Pay Benefits

  - 23 Trust Funds Insolvent in 1983

  - Federal loans of $7.8 billion in 1983

When fund reserves prove inadequate to meet benefit payments, states may borrow from the federal government. In 1969 no state was insolvent. The recessions of the 1970's and 1980's caused an increase in insolvency with, for example, 23 state trust funds insolvent in 1983. In 1986, despite several years of sustained economic growth, 8 state trust funds remained insolvent. Until very recently most trust fund insolvency was concentrated in states in the midwest and northeast. The recent difficulties in energy and related industries has created solvency difficulties to Texas, Louisiana and other energy producing states.

Figure 1 Adequacy and Solvency of State UI Trust Funds, 1969 to 1986



IMPACT OF RECESSION ON SOLVENCY

The UI trust fund reserve has increased from a negative balance of $5.8 billion in 1983 to an historic high of $15.4 billion in 1986, as a result of the extended period of economic growth following the last recession. However, despite this increase in reserve growth, the financial health of many state trust funds is vulnerable to a downturn in the economy.

Projections from the Department of Labor's UI system model predict that if strong economic growth continues through 1992, trust fund reserves will increase, although adequacy will not improve significantly. Aggregate reserves will grow by 62 percent to an estimated high of about $25.2 billion in 1990, yet despite this growth, the High Cost Multiple improves only marginally -- to .45 from .44. This occurs primarily because revenue growth is expected to be just marginally greater than the growth in covered workers.

We also used the Labor model to analyze the possible impact of a moderate recession in 1988 equivalent to the average of the last 5 recessions. While this analysis is subject to the kind of uncertainty associated with any projection of the future, the simulation shows that the financial condition of the UI system could be expected to deteriorate rapidly. The number of insolvent states could more than double from 7 to 17 with total federal loans increasing to $7 billion. Even assuming a recovery in 1989, 17 trust funds would be insolvent in that year, and total federal borrowing would still remain at $5.7 billion.

To further illustrate, even a trust fund considered to be in better than average financial condition is vulnerable to recession. We developed a simulation model of the Massachusetts state trust fund, which has almost $1 billion in reserves and a High Cost Multiple of .61. Under favorable economic conditions, its trust fund reserves will grow more slowly than increases in total workforce payrolls and its financial adequacy will, therefore, deteriorate. Projections also predict that the fund would avoid insolvency during a moderate recession beginning in 1990, although reserves would be reduced to about $90 million. Finally, unless the state changed its tax or benefit structure, its fund would become insolvent in a major recession, eventually requiring an estimated $800 million in federal loans.

CAUSES OF INCREASED INSOLVENCY

Several factors have contributed to the UI system's general decline in solvency, including the high unemployment generated by 3 major recessions since 1970 and the tendency in many states for increases in benefit expenditures to exceed UI revenue growth. (See Table 2 for a summary.)

Table 2 -- CAUSES OF INCREASED TRUST FUND INSOLVENCY

- Higher Unemployment Since 1973 Increased Benefit Costs
  - More Workers Received Benefits
  - More Higher Wage Workers Received Benefits
  - Long Term Unemployment Increased
- Benefit Payouts Increased
  - Many States Tied Benefits to Inflation
  - Revenues Not Indexed
  - Extended Benefits Not Funded

- The American economy's weak performance since 1970 has eroded trust fund solvency. Repeated recessions and economic growth lower than necessary to generate sufficient employment growth in many states have led to higher overall unemployment during the 1970's and 1980's.

- Higher unemployment rates increase UI costs by increasing the number of claims and hence the benefit payments. For example, unemployment in the 1960's averaged about 4.8 percent, compared to 8 percent thus far in the 1980's. In addition, higher unemployment levels are often associated with greater numbers of high wage workers being laid off, also increasing average weekly benefits.

- The 1980's have exhibited higher average rates of long term unemployment --1.4 percent compared to 0.7 percent during the 1970's. Such increases lengthen average benefit duration, thus raising outlays.

- Twenty state programs have indexed benefit levels to inflation but have not indexed their state UI taxes, causing benefit expenditure increases to outpace revenue growth.

- o Extended benefits, as provided under the Federal Employment Security Amendments of 1970, also have contributed to state trust fund financial difficulties because states did not increase revenues to finance their portion of the additional 13 weeks of benefit payments allowed.

FEDERAL POLICY ON INSOLVENCY HAS CONTRIBUTED TO REDUCED WORKER BENEFITS

During the 1980's the Congress enacted a number of provisions which, in essence, make it more expensive for states to exhaust their reserves and borrow from the federal government to pay benefits. To avoid penalties for insolvency or qualify for financial incentives to improve solvency, states were required to cut benefit costs or increase taxes, or both. (See Table 3 for a summary). Actions taken at the federal level include:

-- the charging of interest on federal loans to insolvent trust funds which, prior to 1981, were interest free,

-- enforcing so called "penalty taxes" on employers in states that have not repaid their loans in a timely manner, and

-- providing financial incentives --such as reduced interest rates, the deferral of interest payments or reductions in employer penalty taxes-- to states that have taken action to both reduce benefit expenditures and increase program revenues.

Table 3 -- FEDERAL POLICIES CONTRIBUTE TO REDUCED BENEFITS

POLICIES:

- o Penalty Taxes to Delinquent States Enforced (1980)
- o Interest Charges on Federal Loans to States (1981)
- o Incentives for State Solvency Improvements (1983)

STATE RESPONSE:

- o Eligibility Requirements Tightened
- o Benefit Duration Reduced
- o Weekly Payments Reduced

Although these policies have encouraged states to eliminate existing trust fund debt, as noted earlier, states have not accumulated adequate reserve balances. As of 1986, only 3 of the 31 trust funds which had been insolvent at least once since 1972 (Alabama, Hawaii and Maryland) had regained reserves sufficient to achieve a 1.0 High Cost Multiple.

Reducing benefit costs has, in turn, often meant decreasing the proportion of the unemployed receiving benefits. GAO identified numerous changes in state UI laws during the 1980's which had this effect. Some examples are:

- Since 1981, 6 of the 8 states which had maximum benefit duration exceeding 26 weeks cut them back to the 26 week maximum used by other states.

- 35 states increased the earnings level required for minimum weekly benefits, while 18 states changed their eligibility requirements to reduce the number of unemployed receiving benefits.

- 19 states increased the disqualification penalties for claimants who quit work without good cause, 22 states increased penalties for claimants dismissed because of misconduct, and 20 states increased penalties for claimants who refused suitable work while unemployed.

CONCLUSION

To sum up, despite the recent accumulation of what may appear on the surface to be significant reserves, the UI system remains financially fragile. The number of trust funds with adequate reserves has declined and is likely to increase only moderately even if the economy remains strong. Meanwhile, individual trust fund insolvency has increased dramatically and despite the length of the current economic expansion, seven state trust funds remain insolvent today. Economic projections suggest a significant increase in such insolvencies in the event of another recession, with inadequate reserves leading to increases in borrowing from the federal government to pay benefits.

Without incentives to build adequate reserves while maintaining benefits, many states will likely again implement actions which reduce the proportion of the unemployed receiving benefits. This proportion has declined from nearly half the unemployed during the 1950's to less than a third during the 1980's. In October of this year the proportion of the unemployed receiving benefits was only 26 percent, nearly a record low.

Thus, the present system is operating in a way which fails to encourage states to take action to build reserves during periods of economic expansion. Rather, the system depends heavily on federal borrowing during economic downturns, requiring transfers from general revenues to the UI program.

The Congress should take action to improve the adequacy of UI system reserves to minimize the number of state trust funds becoming insolvent during economic downturns and help avoid multi-billion dollar borrowing from the federal government. Numerous alternative actions are available to the Congress to improve the adequacy of trust fund reserves including, requiring the Department of Labor to establish and enforce adequacy standards, providing financial incentives to states that have adequate reserves, or raising the federal tax to build reserves. Efforts to improve the financial condition of the UI program could result in a reduction in the availability of benefits to workers, therefore, Congress also should be mindful of the need to maintain appropriate levels of worker benefits.