Unemployment Compensation—Overdue For Reform

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Unemployment compensation has been a fixture among American social insurance programs since the Great Depression. However, if present trends continue, it soon could go the way of the dinosaur. Depleted by high unemployment and ad hoc increases in benefit amounts and duration, the Federal Unemployment Trust Fund is headed for bankruptcy. The problem is compounded by a profusion of special federal benefit programs that supplement regular jobless pay for some beneficiaries.

Unemployment compensation was designed to provide cash assistance to tide workers over during periods of temporary, involuntary unemployment. This program is strongly supported by the business community, as a means of stabilizing the supply of skilled labor.

When Congress instituted the unemployment compensation system in 1935, there was strong sentiment for the new system to be wholly federal, but Congress chose to act in partnership with the states. Federal law provides the broad outlines of the system—creation of a state program, its administration, and what types of employment are covered. Within those outlines, the states can determine the amount and duration of cash benefits, criteria for eligibility and disqualification, and how the program is financed.

From the beginning, the federal government assured that it would be a “more equal” partner, by using a “carrot-and-stick” approach. The “carrot” is the Federal Unemployment Tax—a hefty tax on employers, currently assessed at 3.4% of the first $6,000 of annual pay per employee. The “stick” however, is a tax credit of 2.7%—for employers in states whose conformity with federal requirements has been certified by the Secretary of Labor. Each state’s law is reviewed annually by the Labor Department for this purpose.

Administration

The balance of the Federal Unemployment Tax remaining after the tax credit is .7%. These federal tax revenues are used primarily to administer the program through “grants” from the Labor Department. The states use those grants to pay the expenses of their employment security agencies, the governmental entities which actually run the program in each state.

Duration and Financing

Benefits are payable for temporary, involuntary, job-connected unemployment. Extended support for chronic or prolonged unemployment never was intended to be provided throughout the unemployment compensation system.

Most states do not compensate for the first week of unemployment (waiting week). Thereafter, a claimant usually can draw up to 26 weeks (six months) of regular unemployment benefits. Benefits typically replace half of wages, tax-free, up to a maximum set by each state. Funding is provided by a state payroll tax, adjusted for each employer according to the volume of claims filed by former employees.

Congress added a permanent Extended Benefits program to the system in 1970. Extended Benefits provide up to 13 weeks of payments for claimants who exhaust their regular benefits. The extra weeks are financed wholly by the employer payroll taxes: 50% from the federal unemployment tax.

Extended Benefits become payable in a state whenever the national insured unemployment rate (IUR) or the IUR within a state reaches a specified level, often referred to as a “trigger”. Extended Benefits are payable as long as the IUR remains at or above the “trigger” level, but no less than 13 weeks.

From 1974 to 1978 there was a further extension of benefit duration known as Federal Supplemental Benefits (FSB). At first, FSB provided 13 additional weeks of payments financed from the Federal Unemployment Tax. In 1977 Congress renewed the program, adding yet another 13 weeks—for a grand total of 65—but financed them out of general tax revenues. There were insufficient federal tax funds for the initial FSB program, and advances from general revenues were required to fund it. Those advances—totaling nearly $6 billion—never have been repaid and are carried on the books as a liability of Federal Unemployment Tax revenues.

Last year, both houses of Congress passed bills to create another FSB program, although the proposals died in conference. New FSB legislation already has been introduced in the 97th Congress.

Unemployment Trust Fund

State and federal unemployment payroll taxes are held in the Federal Unemployment Trust Fund, administered by the U.S. Treasury Secretary. Balances are included in the federal budget. State unemployment tax revenues are deposited in individual state accounts within the trust fund. Regular benefits and the state half of Extended Benefits are paid out of funds in these accounts.

Federal tax revenues are also divided among several accounts. A full .45% of the .7% tax goes into an ac-

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count for administration expenses. A portion goes into a special Extended Benefits account, and part goes into a special loan fund for states whose benefit outlays temporarily exceed their tax revenues. Two-tenths percent of the .7% tax is applied to the Extended Benefits and Federal Supplemental Benefits debt (about $9 billion, combined).

Presently, 14 states and 3 territories have borrowed more than $6.1 billion from the loan fund; 11 of those 17 jurisdictions now are in default on part of their debt. There is no penalty, but federal law includes a recapture provision for states that default: Employers in the defaulting state lose a portion of their Federal Unemployment Tax credit in .3% increments for each year default continues.

**The Program Breaks Down**

The unemployment compensation system ran fairly smoothly until the 1970’s. Since then, federally mandated extensions of duration, together with automatically escalating state benefits and several downturns in the economy (which create peak levels of unemployment) played havoc with program financing.

The present problems within the program include the following:

- **Extensions of Duration**—A large part of the strain is attributable to the Extended Benefits and Federal Supplemental Benefits programs. These extensions of benefit duration were enacted without adequate provision for financing. Moreover, economic studies have demonstrated that such ad hoc increases in benefit duration merely allow claimants to postpone effective job search—directly running up the cost of regular benefits.
- **Misfiring Extended Benefits “Triggers”** — A nationwide Extended Benefits period begins when the national Insured Unemployment Rate (IUR) reaches 4.5%. However, economic downturns do not always have the same impact in all parts of the country. For example, the present IUR is almost 8% in Michigan, but less than 2% in Oklahoma, Texas and Wyoming. The result is that a nationwide Extended Benefits period provides extra benefits for workers in states where labor is in short supply.

A state Extended Benefits period begins, independent of the national unemployment rate, if the statewide IUR is 4%, and 20% higher than for the preceding two years. Alternatively, a state may elect to pay Extended Benefits when the statewide unemployment rate is 5%, regardless of the 20% factor, and about two thirds of states have elected to do so. These rates may have represented unusually high unemployment in 1970, when the Extended Benefits program was enacted, but changes in employment patterns over the last decade suggest that now they are too low.

- **Federal Loans** —The federal loans were intended to tide a state over when unexpectedly high unemployment caused a temporary depletion of balances in its trust account. However, the very fact that two-year, interest-free loans are available has invited abuse of the loan fund by state officials, who borrow to fund benefit increases, thereby avoiding tax increases. Indeed, dip-
ping into the loan fund and repaying—several years later with inflated dollars may be sound money management on the part of state officials.

• Socialized Costs — Unemployment compensation was designed to operate as an insurance program. As claims for benefits are filed, the tax rate for the responsible employer is adjusted (a process known as experience rating). In some states, however, a large part of benefit costs is socialized—not charged to the responsible employer. For example, a few states do not experience rate an employer’s account for Extended Benefits claims; others socialize the cost of benefits paid to persons who leave their jobs voluntarily or who worked for government entities or non-profit employers.

• Fraud and Improper Payments — A recent study by a national commission found that, in some parts of the country, as much as one-third of all benefits paid out were improper payments. Ironically, agency staff devoted to fraud and error control are the first to be cut as “non-essential” employees when budget reductions are made.

• Claimants Who Refuse Work — Under current law, claimants who refuse to accept “suitable work” are disqualified from receiving unemployment benefits. Suitable work usually is defined as a job similar to the claimant’s previous employment. That definition is appropriate for the initial period of unemployment, when the claimant has a reasonable expectation of being recalled. But subsidizing a career-oriented, prolonged job search merely discourages workers from adjusting to permanent changes in employment patterns. Present law allows workers to draw up to half a year of benefits while searching for their customary work, needlessly running up program costs for persons who could be working.

• Attachment to Labor Force — Unemployment benefits are not welfare; therefore, they are intended to be payable only to persons who have a demonstrated “attachment” to the labor force. All states require some demonstration of previous work as a criterion for receiving unemployment compensation, but some states’ requirements are very slight. In those states claimants may receive regular and Extended Benefits for up to nine months—often far longer than they worked.

• Benefits in Case of Strike, Voluntary Quit, or Misconduct — An important eligibility test for receipt of unemployment benefits is involuntary loss of work. However, in many situations, benefits are paid to claimants who leave their jobs voluntarily, without good cause connected to employment. A few states permit unemployment benefits to be paid to strikers. In those states, employers are forced to subsidize the strike against them.

The availability of benefits for persons who quit their jobs is an incentive for rapid job turnover, undermining one of the fundamental purposes of an unemployment insurance program—stabilizing the labor supply.

• Special Benefit Programs — Although 97% of American workers are covered by the regular unemployment compensation program, a number also are eligible for supplementary benefits under approximately 20 separate federal programs serving limited constituencies. These special programs, such as Trade Adjustment Assistance, typically pay higher weekly benefits, and for a longer duration, than regular unemployment compensation. In fact, most employees have returned to work long before their benefits are received. Experience with the special programs reveals that the added benefits are superfluous at best and, at worst, prolong the duration of unemployment.

• Low Return on Trust Fund Balances — State unemployment tax revenues are held by the Treasury Department in the Unemployment Trust Fund and invested for the states by Treasury. Responsibility for maintenance, as well as investment, of funds rests with the Treasury Secretary. Current practice is
for the Secretary to invest the funds solely in federal obligations—some at relatively low yields by today’s standards—and in relatively long-term securities. As a result, the states receive a comparatively low return on their monies held in trust, a better rate of return would help relieve the pressure to raise taxes.

- **Failure to Require a Waiting Week**
  Most states require that unemployed workers wait one week before becoming eligible for unemployment compensation. Use of a waiting week keeps down administrative costs by excluding claimants whose unemployment is of brief duration, and, more significantly, is an incentive for unemployed workers to seek new employment without delay.
  However, some of these states pay benefits for the first week retroactively; some have no waiting week requirement whatsoever.

- **Maldistribution of Administrative Costs**
  Projected revenues from the Federal Unemployment Tax are insufficient to cover the expected costs of program administration over the next several years. One reason is that services performed for non-profit, religious, charitable, educational and humane organizations, as well as for a state and its political sub-divisions, are exempt from the Federal unemployment Tax whose revenues are used to finance administration of the program.
  Employers that are exempt from the federal tax make no contribution toward the cost of program administration, even though their employees receive unemployment benefits. Private employers, therefore, subsidize administration costs for all non-profit and public employers.

- **Conformity of State and Federal Laws**
  Once a year, the Labor Secretary must review each state’s unemployment compensation law, to determine whether it conforms with all federal requirements. A state that fails to meet every requirement is decertified, resulting in a Federal Unemployment Tax increase of more than 385%. The state must also refund to the Labor Department all money used to administer the state’s unemployment benefit program. New Hampshire is now paying a $500,000 penalty for failure to cover certain government workers in 1978 and 1979, but risked a possible liability of $45 million.
  A similar situation on a larger scale is facing employers in a dozen states that have challenged a Labor Department ruling requiring coverage of church-school employees. The business community has the responsibility to insist that if employees are properly covered; if they are not, it is fair for business to pay the penalty. If a state refuses to cover government or non-profit employees as required, however, it is grossly inequitable—and potentially ruinous—to penalize business.

**Solutions**
To find solutions to those myriad problems, careful scrutiny of the unemployment compensation system is in order—and cooperation among business, labor, and government leaders is essential. The federal-state partnership has functioned successfully for most of its history, but its very duality has allowed problems to grow as officials in Washington and the state capitals “pass the buck” back and forth. It is time for the federal and state governments to take responsibility for their respective portion of the program.

The foremost step that Congress could take to ease the pressure on the unemployment compensation system is to restore the vitality of the national economy. An improvement in the employment situation certainly would provide immeasurable relief. However, lasting reform would require permanent amendments to unemployment compensation laws.

The mood of fiscal responsibility in Washington is conducive to constructive change. The 9th Congress, in its waning days, acted on a number of proposed improvements in the program, focusing on Extended Benefits.

President Reagan’s new program for economic recovery includes measures that would carry the reform process a few steps further. Corrective modifications of the federal unemployment compensation laws that would help restore the program to solvency include the following:

- **Target Extended Benefits to states that require assistance, by elim-**
inating the “national trigger.”

- Raise the Extended Benefits “state trigger” to 5% insured unemployment rate, plus 20% higher than the preceding two years, with an option to set the trigger at 6% insured unemployment or higher, regardless of the rate for the preceding two years.
- Exclude Extended Benefits claims from the formula for calculating the insured unemployment rate for “trigger” purposes.
- Require a strong attachment to the workforce to qualify for Extended Benefits.
- Charge interest on future federal loans, and prohibit borrowing states from increasing benefit costs while such loans are outstanding.
- Permit states currently in default to avoid loss of the Federal Unemployment Tax credit, by electing to repay an amount equivalent to the amount that loss of the credit would raise.
- Prohibit federal advances to states that socialize a high proportion of benefit costs on average over 5 years.
- Strengthen enforcement against fraud and abuse, by requiring state agencies to allocate adequate staff to control improper payments.
- Require that special federal unemployment benefits be paid only at the same weekly rate and for the same duration as regular benefits. If special benefits must be payable, they should be limited to persons who agree to enter retaining programs.
- Allow states to control investment of a portion of balances in their trust funds.
- Require that states to include their unemployment trust account balances in their state budgets, to encourage fiscal responsibility in balancing benefits against tax revenues.

- Remove coverage of government, non-profit and religious organization employees as a criterion for certification of a state law.
- Charge debts from the expired Federal Supplemental Benefits program, which should never have been employers’ liability, to federal general revenues.

Federal law changes would solve only a small part of the problem—action by the state legislatures is also necessary. The U.S. Chamber long has urged its members to continually review and analyze their state unemployment compensations laws, and to work with state business organizations to assure that their program is well and up-to-date. It is up to the states, after all, to keep socialized costs to a minimum; to deny benefits to claimants who voluntarily leave their jobs, go out on strike, or refuse offers of suitable work; to insist on a real attachment to the workforce to qualify for benefits; or to impose a waiting week requirement.

In the final analysis, the states must take responsibility for sound financing, or risk losing control over benefits and taxes to the federal government. The need for federal benefits standards has been a matter for debate since the inception of the program, usually as a means of increasing benefits.

The business community has consistently opposed federal standards, whether favorable to employers or not, on the ground that the states are better able to make decisions concerning benefit amount, duration, eligibility, or disqualifications. Nevertheless the sentiment has been growing among Members of Congress in favor of standards that would cut program costs. Unless the states move forward, the federal government may find the pressure irresistible.