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BTC Brief

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THE PATH TO INSOLVENCY: Tax Changes, Great Recession Drive Unemployment Insurance Trust Fund Challenges

*Timely,
accessible,
and credible
analysis of
state and local
budget and tax
issues*

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KEY FINDINGS:

- The Unemployment Insurance system works thanks to “forward financing”—employers contribute to an unemployment insurance trust fund in good times so that in tough times, when benefit payouts increase and payrolls shrink, funds are available for workers who lose their jobs through no fault of their own.
- In the mid-1990s, North Carolina’s policymakers enacted a series of tax changes that moved the state effectively to pay-as-you-go financing and set the state up for the current insolvency challenges with the Unemployment Insurance Trust Fund.
- If North Carolina had required contributions from employers at the national average tax rate during the past two decades, the UI Trust Fund would have \$2.8 billion by 2004, potentially erasing the current solvency issues.
- Because of a combination of tax cuts and significant and sustained job loss in the Great Recession, North Carolina, like 30 other states, has borrowed from the federal government to sustain the day-to-day delivery of unemployment benefits.
- Policymakers must put together a solvency plan that rectifies the tax changes made in the 1990s and ensures that all employers are contributing to this critical program that supports families, business and communities in tough times.

A Strong Unemployment Insurance System is Critical in an Economic Downturn

The federal government established the unemployment insurance financing system after the Great Depression to support workers and ensure that the economy could recover in the face of massive job loss. The system works thanks to “forward financing”—employers contribute to an unemployment insurance trust fund in good times so that in tough times, when benefit payouts increase and payrolls shrink, funds are available for workers who lose their jobs through no fault of their own.

This countercyclical function of the unemployment insurance system is essential to sustaining the promise of economic recovery—without benefit payouts, the unemployed cut back on spending, decreasing consumer demand and slowing economic growth. Indeed, recent national data from the

American Community Survey found that unemployment insurance benefits kept 3.3 million Americans out of poverty from 2008 to 2009.¹

Unfortunately, North Carolina cut its required contributions from employers to the state’s unemployment insurance (UI) trust fund during the economic boom of the 1990s. Today, those cuts along with the high and sustained unemployment of the past several years have put the UI trust fund in the red. This *BTC Brief* explores the causes of the trust fund’s insolvency and the need for forward financing in the future.

Tax Cuts are Primary Driver of UI Trust Fund Insolvency

In the mid-1990s, North Carolina’s policymakers enacted a series of tax changes that moved the state effectively to pay-as-you-go financing (See Figure 1). These changes brought the state’s unemployment insurance trust fund levels below safe levels proscribed by the best evidence—just before the first recession of the 2000s hit. The result is that employers are making greater contributions as a share of total wages (1.6 percent) in 2009 than they were in 2000 (0.6 percent).² The lowest tax paid by employers was 0.2 percent in 1996—a year when the economy was better and the state should have been building up the trust fund.

Indeed, the balance of the UI trust fund fell precipitously in the 1990s, leaving the state’s unemployment insurance system ill-prepared for the current recession.

North Carolina’s Unemployment Insurance Trust Fund Could Have Been Solvent Today

Prior research by the Budget and Tax Center identified that the tax changes of the 1990s removed \$1.5 billion from the unemployment insurance system.³ The full loss to the Unemployment Insurance Trust Fund is complicated to calculate, however, but can be approximated by looking at the average tax rate in North Carolina versus the nation. If North Carolina had required contributions from employers at the national average tax rate from 1990 to 2004, the UI Trust Fund would have had \$2.8 billion in 2004, potentially erasing the current solvency issues.

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

The Great Recession Required Borrowing at the Current Level

In addition to short-sighted tax cuts, the failure of payroll to rebound after the 2001 recession was in part to blame for North Carolina’s precarious position entering into the last recession.⁴ The duration and severity of the state’s unemployment levels in the Great Recession further compounded the demand for unemployment insurance benefits.

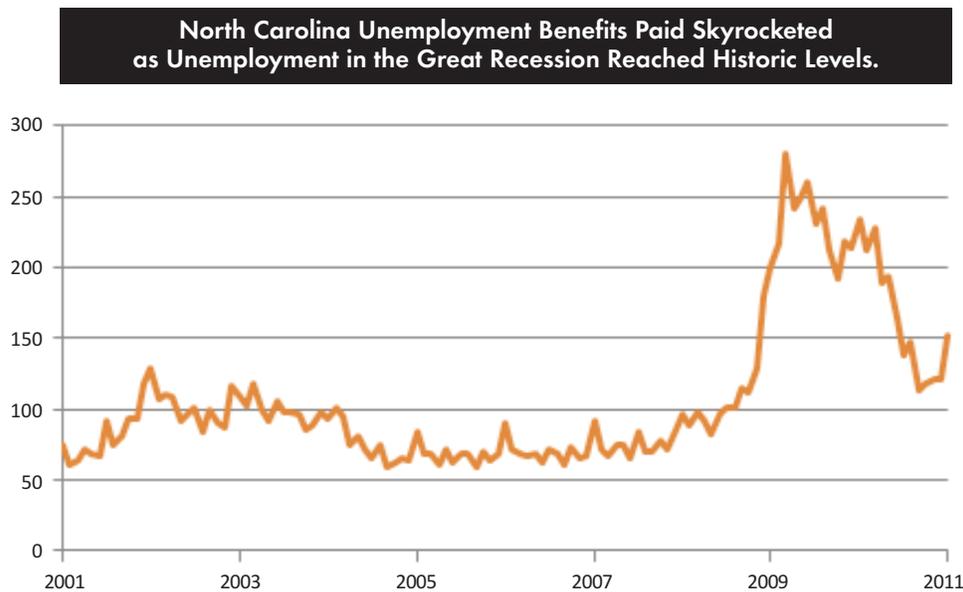
In the seven years leading up to the Great Recession, average monthly UI

SOURCE: NC Employment Security Commission

benefit payouts totalled \$81.4 million. At the peak of the Great Recession in March 2009, the monthly payout was \$280.5 million, more than three times the previous level.⁵ The unemployment rate in that month was 10.4% compared to 4.5% in March 2007.⁶

In addition, North Carolina has lost covered employers in recent years. As of March 31, 2010, there were 197,956 covered employers in the state responsible for contributing UI taxes compared to 198,849 at the end of the prior quarter, and 202,374 at the end of March a year ago.⁷

Because of all of these factors, North Carolina, like 30 other states, has borrowed from the federal government to sustain the day-to-day delivery of unemployment benefits. Nationally, states have borrowed \$44 billion; North Carolina has borrowed more than \$2.6 billion.⁸



SOURCE: US Department of Labor, Employment and Training Administration. Benefits paid monthly from January 2001 to January 2011.

Unemployment Trust Fund Solvency Must Re-Establish Forward Financing over Time

The current situation is one that has taken more than a decade for North Carolina to get in and will require time to resolve. But state leaders need to address it, as the unemployment insurance system plays a critical role in smoothing the ups and downs of the business cycle and maintaining the spending that supports economic recovery. Policymakers must put together a

solvency plan that rectifies the tax changes made in the 1990s and ensures that all employers are contributing to this critical program that supports families, business and communities in tough times.

- 1 American Community Survey, 2009.
- 2 Department of Labor, Division of Fiscal and Actuarial Services
- 3 Jordan, Elizabeth. June 2003. *BTC Reports: Are North Carolina Employers Paying Too Much in Unemployment Insurance Taxes?* N.C. Budget and Tax Center: Raleigh, NC. Tax changes from N.C. Employment Security Commission
- 4 Quintero, John. March 2007. *Buddy Can You Spare a Dime? Putting North Carolina's Unemployment Insurance System Back to Work.* North Carolina Justice Center, Raleigh, NC.
- 5 Department of Labor, Employment and Training Administration
- 6 Local Area Unemployment Statistics, March 2009 and 2007
- 7 ESC, March 2010
- 8 US Department of Labor, Trust Fund Loans as of March 7, 2011. Accessed at www.ows.doleta.gov/unemploy/budget.asp#floods