# Financing an Effective Unemployment Insurance System: Protecting Working Families, Our Communities & Minnesota's Economy

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## I. Introduction

Established by Congress in 1935, the unemployment insurance (UI) program was created to provide "the first line of defense" against economic hardship during recession. In 1995 the Advisory Council on Unemployment Compensation (ACUC), a bipartisan body appointed by Congress and Presidents Bush and Clinton in 1993, outlined the program's goals:

> "The related goals of the UI program are providing involuntarily unemployed workers with adequate, temporary income replacement as well as automatically stabilizing the economy by using accumulated trust funds to maintain consumer spending during an economic downturn. Secondary goals include supporting the job search of unemployed individuals by permitting them to find work that matches their prior experience and skills, as well as enabling employers to retain experienced workers during layoffs."[1]

Unemployment insurance is designed to pay adequate weekly benefits so that jobless workers and their families can maintain essential family spending. In the face of ongoing job loss and dislocation, Minnesota's UI program also automatically boosts our economy by maintaining consumer spending during a recession.

This briefing paper by the Minnesota JOBS NOW Coalition and the National Employment Law Project (NELP) analyzes the recent economic impacts of UI benefits in Minnesota; it also examines the current financing structure and makes recommendations for its improvement. The program's continued positive economic impact on Minnesota's working families and economy will depend on maintaining a strong foundation through a sound UI financing structure.

## II. Positive Economic Impacts of Unemployment Insurance

Although the economic benefits of UI programs are widely acknowledged by economists, at times they are not taken into account by policy-makers, businesses and members of the public. Too often, policy-making focuses on the narrow question of whether a tax rate will increase or decrease. But confining ourselves to a narrow "tax burden" approach is like analyzing a stock's value by looking at corporate expenses without considering income. Not surprisingly, this kind of limited analysis undercuts support for the UI program and undervalues its role in protecting the economy, workers and communities from the destabilizing effects of economic downturn.

For critics of unemployment insurance, UI benefits disappear as soon as the checks to jobless workers are mailed. This is economic nonsense. Laid off workers spend almost all of their UI benefits on their daily expenses. These include: rent, mortgage payments, utility bills, groceries, gasoline, and medical bills. In other words, UI benefits stabilize consumer expenditures, thus ensuring a floor on consumer spending for Minnesota businesses.

There is an abundance of research showing the positive economic impact of UI benefits. A 1999 U.S. Department of Labor study found that for every $1.00 of UI benefits paid to laid off workers, $2.15 in

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[1] Advisory Council on Unemployment Compensation, Unemployment Insurance in the United States: Benefits, Financing, Coverage (U.S. Department of Labor, Washington D.C., 1995), p.8.

increased economic activity (growth in GDP) was produced.[2] Analyzing the last five recessions, the report's authors estimated that the recessions were 15 percent milder and had fewer layoffs than would otherwise have occurred but for UI's contribution to consumer spending. The report was based on a widely-used Wharton economic forecasting model for the national economy. Furthermore, over the last year Nobel prize winner Joseph Stiglitz, Federal Reserve Board chair Alan Greenspan, and *New York Times* economic columnist Jeff Madrick have all called for extending UI benefits to stimulate the economy.

***UI benefits maintain consumer spending in Minnesota's economy***

Injecting UI benefits into local economies helps Minnesota just as it does the national economy. As shown in Table 1, we calculate that together federal and state benefit payments infused nearly $1.7 billion into Minnesota's economy during 2001 and 2002; even after subtracting taxes paid by business, there was a net influx of $1 billion.

As early as November 2000, applications for unemployment benefits began to show a marked increase over the previous year, months before the national recession began in March 2001. During 2001 and 2002, the unemployment rate ranged from 3.2% to 4.9%; and in some parts of the state, it reached 20%.[3] During these two years many communities in Greater Minnesota experienced substantial job loss with the closings of large employers, including: LTV Steel in Hoyt Lakes; Fingerhut in St. Cloud, Mora and Eveleth; and Blandin Manufacturing in Grand Rapids. While the official recession may be over, job loss continues unabated in Minnesota and long-term unemployment remains at record levels.[4]

During this two-year period, three different types of benefits were paid to eligible unemployed workers. These include up to 26 weeks of regular UI benefits paid out of the state trust fund and the special state extensions implemented during the 2002 legislative session. In addition, since March 2002 jobless workers who exhausted state UI benefits were eligible for up to 13 weeks of federal Temporary Emergency Unemployment Compensation (TEUC) benefits; and the state paid for the identical extensions for those who exhausted regular Minnesota benefits but were not eligible for TEUC. The state also funded an additional 13 weeks of extended benefits for workers in the airline and related industries and workers who lost jobs with Fingerhut. Federal benefit extensions will not be recovered from Minnesota's employers through future state UI payroll taxes, as with regular state benefits. Special state extensions are only a small part of the total benefits paid out and will have a small effect on employer taxes paid.[5]

When we compare state UI taxes paid by employers to benefits paid to employees during this two-year period, we see how Minnesota's UI system helped the state's economy.

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[2] Lawrence Chimerine, et al., "Unemployment Insurance as an Economic Stabilizer: Evidence of Effectiveness Over Three Decades," U.S. Department of Labor, Employment and Training Administration, UI Occasional Paper 99-8 (1999) available at http://workforcesecurity.doleta.gov.

[3] Clearwater County, January 2001.

[4] National Employment Law Project, "Crisis of Long-term Unemployment is Far From Over," February 27, 2003. Found at www.nelp.org.

[5] Federal UI funds come from an .8% federal tax on all private employers. It is imposed on the first $7000 in annual wages and amounts to a maximum of $56 per employee. These funds pay for state agency administration, the federal share of extended benefit program, and a loan fund. Federal trust funds are the source of the current temporary federal extension, as well as the one-time federal Reed Act funds ($163 million) Minnesota's UI trust fund received in March 2002.

**Table 1: Total UI Stimulus to Minnesota's Economy**

| | |
|---|---|
| State and federal UI benefits paid in '01 | $670,000,000 |
| State and federal UI benefits paid in '02 | $1,066,000,000 |
| Less Taxes Paid by Employers in '01-'02 | -$690,000,000 |
| **Net Benefits of UI Programs** | $1,046,000,000 |

As shown by in Table 1, we estimate that net benefit payments (including regular benefits and both state and federal extensions) infused over $1 billion into Minnesota's economy during 2001 and 2002.

***UI benefits maintain a stable workforce***

There are more ways that a well-functioning UI system serves the economy. A strong UI system ensures that unemployed workers and their families can avoid unnecessary hardships produced by the ups and downs of the business cycle. Rigorous research has documented how UI prevents poverty, thwarts hunger, prevents foreclosures and enables workers to retain hard-earned savings. For example, MIT Economist Jonathan Gruber finds that UI cuts mortgage foreclosures by unemployed workers in half.[6] UI becomes especially important during economic downturns. One evaluation found that UI reduced the poverty among workers from 70% to 40% during the recession of the early 1990s.[7] UI can make the difference in how a worker experiences unemployment: it can be a temporary decline in living standards between jobs instead of a longstanding crisis.

Moreover, in good times and bad, UI helps the labor market operate more effectively. In today's economy, it takes time to match up workers with appropriate employers. UI provides support for laid-off workers as they conduct a search for a job that best fits their prior skills and experience—support that can increase reemployment wages by as much as 30%.[8] UI also helps employers who lay off workers during temporary downturns. By providing workers with adequate support until they can be rehired, UI enables such employers to retain a skilled, experienced workforce.[9]

## III. Evaluating Minnesota's Unemployment Insurance Program

The most important foundation to the UI system is its financing mechanism. In Minnesota the solvency of the UI fund has been at issue for a number of years. Thus, the remainder of this report will compare Minnesota's UI program to other states and will then analyze the financing structure with an eye towards maintaining a strong foundation for the program.

In past evaluative reports of state UI programs, NELP noted shortcomings of Minnesota's UI program, especially financing and monetary eligibility issues. A March 2002 report, "Failing the Unemployed,"

[6] Gruber (1995) "Unemployment Insurance, Consumption Smoothing, and Private Insurance: Evidence from the PSID and CEX," Advisory Council on Unemployment Insurance Background Papers, Vol. 1.

[7] Corson, et al. (1999) "Emergency Unemployment Compensation: The 1990s Experience," Mathematica Policy Research, published by U.S. Department of Labor as Unemployment Insurance Occasional Paper 99-4.

[8] Ehrenberg and Oaxaca (1976) "Unemployment Insurance, Duration of Unemployment, and Subsequent Wage Gain," The American Economic Review, Vol. 66, no. 5, 754-766.

[9] Minnesota is one of 18 states that operates a "short-time compensation" program, allowing companies to retain their workers while cutting back their hours. Reduced hours are compensated for in part by the UI system.

showed the weaknesses of many state UI programs. In that report NELP (along with co-authors Economic Policy Institute and the Center on Budget and Policy Priorities) found that 23 of the 51 states "failed" three of five tests used to judge the basic adequacy of UI programs.[10]

In the overall context of all state UI programs, we judge Minnesota's UI program as "above average." It is worth noting that a majority of UI programs have serious shortcomings.[11] While Minnesota's UI program shares some of these shortcomings, especially with regard to financing, it still merits an overall above average rating based upon its adequate benefit levels, largely fair UI eligibility rules, and competent administration.

### A. Comparing Minnesota's UI Program with Midwest States

Minnesota's UI program compares well with other states in the Midwest.[12] Table 2 and the descriptions below explain how Minnesota compares to other Midwest states and the national average.

*Percent of Unemployed Collecting UI benefits:* UI recipiency is an important indicator of the health of a state's UI program. If a low percentage of unemployed workers get UI benefits, this undercuts both the income replacement and economic stimulus goals of the program. Column 1 of Table 2 provides the ratio of the insured unemployment rate to the total unemployment rate (often termed "recipiency rate"). At 48 percent for 2001, Minnesota is above the national average of 43, but below the recipiency rates of Wisconsin, Indiana, Iowa, and Michigan. Minnesota is well below the recipiency levels in states with stronger UI programs that typically have recipiency ratios above 60 percent. In order to rank with the stronger UI programs in the Midwest, Minnesota's program must increase its recipiency rate.

*Average Weekly Benefit & Weekly Benefit as a Percent of Minnesota's Average Weekly Wage:* Adequate wage replacement is another key indicator of the health of a UI program. The accepted "rule of thumb" for adequacy of benefits is a 50 percent wage replacement, up to a maximum weekly benefit equal to two-thirds of statewide average wages. Minnesota's average weekly benefit amount of $302 (column 2) replaces 45 percent of statewide average wages. Minnesota's "replacement rate" is above the national average and among the higher replacement rates in the Midwest region.

*Average High Cost Multiple & Average Tax Rates:* Columns 4 and 5 of Table 2 are measures of UI financing and trust fund adequacy. Minnesota, North Dakota, and Illinois are the least solvent UI programs in the Midwest. Minnesota's UI taxes are comparable to or lower than most Midwest states and were below the national average in 2001. Because Minnesota's trust fund entered this economic downturn with reserves below recommended levels, UI taxes have already risen and will rise again soon.

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[10] National Employment Law Project, Center on Budget and Policy Priorities, and Economic Policy Institute, "Failing the Unemployed: A State by State Analysis of Unemployment Insurance Systems," March, 2002. Found at www.nelp.org.

[11] While Minnesota is "above average," it is worth noting that twelve to fifteen states, mostly in the South and Southwest, have inadequate UI programs that completely fail to protect jobless workers, and a considerable number of other states have policies that fall well short of best UI practices.

[12] UI is one program for which many advocate that states rank as "average" or "middle of the road," rather than first in the nation. For this reason, interstate comparisons for UI programs are commonly efforts to enforce a "lowest common denominator" against any UI program or feature that is above average. Few would argue that a state's highways or public health system should not be above average and we don't believe that a different approach is warranted for UI.

**Table 2: Key Indicators of Midwest UI Programs**

| State | Percent of Unemployed Collecting UI (CY 2001) | Average Weekly Benefit (Nearest $) | Weekly Benefit as Percent of State Avg. Weekly Wage | Average High Cost Multiple (CY 2001) (1.0 = One Year) | Average Tax Rate on Total Wages |
|---|---|---|---|---|---|
| **Minnesota** | 48% | $302 | 45.0% | 0.35 | 0.4% |
| **Illinois** | 44% | $274 | 36.9% | 0.31 | 0.5% |
| **Indiana** | 56% | $250 | 41.6% | 1.31 | 0.4% |
| **Iowa** | 53% | $255 | 47.1% | 1.14 | 0.7% |
| **Michigan** | 50% | $261 | 36.8% | 0.65 | 0.7% |
| **Missouri** | 40% | $206 | 33.8% | 0.31 | 0.4% |
| **Nebraska** | 36% | $212 | 39.7% | 0.78 | 0.2% |
| **North Dakota** | 44% | $220 | 46.1% | 0.28 | 0.8% |
| **Ohio** | 45% | $251 | 39.9% | 0.54 | 0.4% |
| **South Dakota** | 23% | $194 | 40.8% | 0.72 | 0.2% |
| **Wisconsin** | 57% | $244 | 40.8% | 0.92 | 0.7% |
| **United States** | 43% | $238 | 36.1% | 0.75 | 0.5% |

## B. Minnesota's UI Payroll Taxes and Trust Fund Reserves

This section provides an overview of the structure of UI funding, as well as an analysis of Minnesota's taxes and trust fund reserves.

***A "Forward financing" approach aligns the UI with counter-cyclical economic goals***

Unemployment insurance programs are self-financing. Benefits are financed through employer payroll taxes retained in a UI trust fund account in the federal treasury. All state UI programs impose payroll taxes on employers to finance their UI benefits;[13] the taxes are separate from the overall state budget and general revenue taxes. Funds are drawn down by the states solely to pay benefits. A separate federal payroll tax (authorized under the Federal Unemployment Tax Act and known as "FUTA") funds the administration of state UI agencies and some federal UI functions, including the payment of federal extensions and the federal loan fund.[14]

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[13] Employees make a very small UI contribution through payroll tax deductions in Alaska (.5%) and New Jersey (.2%). Other states, including Pennsylvania, use employee contributions only as a backstop when solvency is low.

[14] Federal UI funds are derived from an .8 percent uniform federal tax on all private employers that is imposed on the first $7000 in annual wages--amounting to a maximum of $56 per employee. These funds pay for state agency administration, the federal share of EB, and a loan fund for insolvent state UI trust funds. Federal trust funds are the source of the current temporary extensions; and federal funds were also the source of a one-time federal "Reed Act" distribution of $163 million deposited in Minnesota's UI trust fund in March 2002.

The federal government pays interest on state UI trust fund reserves held in the federal treasury. States with inadequate trust funds to pay benefits during a downturn must borrow funds from the federal government, pay interest on that borrowing, and repay those debts with higher taxes and/or benefit reductions or restrictions.[15]

Social insurance programs like UI were designed for accumulating trust funds in advance of the payment of benefits. In other words, UI was designed to be "forward funded," rather than to pay benefits from current revenues. By forward-funding and paying benefits from trust fund reserves, states avoid raising payroll taxes or restricting benefits during a recession. During an economic downturn, either of these responses to higher UI claims would undermine the counter-cyclical goals of the UI system. States with adequate trust fund reserves can effectively amortize higher UI claims during a recession by rebuilding reserves after the worst of an economic downturn is over and firms can afford higher UI payroll taxes. States with higher reserves can also finance a portion of their current UI benefits from federal interest payments.[16]

The ACUC recommended that states "should accumulate adequate [trust] funds during periods of economic health in order to promote economic stability by maintaining consumer purchasing power during economic downturns."[17] This recommendation is consistent with the design of UI programs and the practice of the majority of states. There are three widely-used standards for analyzing solvency of trust funds. These are described to the right.[18]

**Three Ways to Analyze UI Trust Fund Solvency**

The following three standards are used to analyze trust fund solvency:

The **Reserve Ratio** or **Trust Fund as Percent of Total Wages** is a state's trust fund balance as a percent of total wages for the past 12 month period. This comparison of trust fund reserves with state wages roughly approximates the risk being insured by unemployment insurance (loss of wages). Reserve ratios are useful because they reflect the growth of a state's economy.

A **High Cost Multiple (HCM)** of 1.0 means that a state has a year's reserves at its historically highest level of benefit payments without relying upon UI payroll tax revenues. An HCM of 0.5 converts to six months, and so forth.

The **Average High Cost Multiple (AHCM)** was adopted in the 1990s following criticism that HCMs were too ambitious for states to meet. A state's AHCM is the average of the three most recent high cost calendar years that include either 3 recessions or at least 20 years of payment history. The ACUC recommended in 1995 that states maintain a pre-recession AHCM of 1.0.

In the 1980s several states, including Texas, Illinois, and Pennsylvania, explicitly abandoned "forward funding" and shifted to what its supporters called "flexible financing"—a system more accurately described as "pay-as-you-go financing." In the case of a forward financed trust fund, the state will earn interest on the trust fund

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[15] A general overview of UI federal and state taxation can be found in Wayne Vroman, Topics in Unemployment Insurance Financing (Kalamazoo, Michigan, Upjohn Institute, 1998). For more information about the separate federal UI payroll tax that finances state UI administration, federal oversight, and the federal loan and extended benefits trust funds, see, U.S. Congress, House Ways and Means Committee, Background Material and Data on Programs within the Jurisdiction of the Committee on Ways and Means (2000 Greenbook), pp. 305-309.

[16] For example, in Kansas in the mid-90s federal interest payments amounted to up to 40 percent of UI benefit payments.

[17] Advisory Council on Unemployment Compensation, Unemployment Insurance in the United States: Benefits, Financing, Coverage (U.S. Department of Labor, Washington, D.C. 1995), p. 8.

[18] Minnesota has maintained low trust fund reserves under all three measures for several decades. For further information on UI financing, see Marc Baldwin, "Boom and Bust: Financing Unemployment Insurance in a Changing Economy," (National Employment Law Project, April 2001) and Wayne Vroman, Topics in Unemployment Insurance Financing (Upjohn Institute, 1998).

paid by the federal government. Since states are legally obligated to pay UI benefits regardless of their trust fund balance, an insolvent trust fund means that a state must either borrow from the federal government loan fund or seek private financing. In a pay-as-you-go system, employers end up paying interest and other financing costs through higher payroll taxes, or through solvency taxes imposed by federal law to ensure repayment of federal loans.

***Minnesota's UI Financing structure failed to support economic conditions***

Minnesota's UI trust fund consistently ranks in the bottom ten in the nation. The "state's fund balance has trailed the national averages by a significant amount over at least the last 30 years," according to a 2002 report by the Office of Legislative Auditor.[19] Minnesota has consistently failed to meet all three accepted standards of solvency. For the end of the 2nd quarter of 2002, Minnesota's trust fund balance ranked 48th, 51st, and 51st on the three measures of UI trust fund solvency.

A closer look at tax rates charged to Minnesota employers under current law reveals that most employers pay taxes at the bottom of the distribution in both Minnesota and the nation. For example, at the beginning of last year, a majority of employers (64%) in Minnesota paid only a 0.1% unemployment insurance tax, the minimum "base" rate in the state.

Compared to most other states, the average Minnesota employer has contributed less to maintaining an adequate UI safety net. An annual survey of 36 states conducted by the US Department of Labor found that only 13% of employers paid such a low 0.1% tax. In the surveyed states the average employer contributed 0.8% of taxable wages to their state's UI trust fund—8 times the 0.1% rate that was paid by 64% of employers in Minnesota in 2002.[20]

Minnesota last experienced serious UI trust fund shortfalls in the recessions of the early 1980s. The impact of recession-level claims in the 70s depleted Minnesota's trust fund, leading to borrowing in the 70s and 80s. Minnesota borrowed roughly $1 billion from the federal trust fund between 1980 and 1985. At the same time, employer taxes rose and surcharges were imposed to repay outstanding federal loans. In 1987 Minnesota adopted a range of trust fund reserve targets and reduced minimum tax rates on employers with low claims; the maximum tax rate was raised at the same time. At the time, policymakers did not

**Features of Minnesota's UI Taxes**

Taxable Wage Base: UI payroll tax rates are imposed on a "taxable wage base," rather than on total wages paid to every employee. In Minnesota the taxable wage base is indexed to the state's wage growth and was $21,000 in 2002.

Employers' UI tax rates are set based upon two components:
Base Rate: The base rate is tied to the balance in the trust fund and fluctuates between 0.1 percent and 0.6 percent.
Experience Rate: The experience rate portion of the payroll tax is based upon the prior claims experience of each individual employer. A firm's experience rate rises as valid claims for UI benefits are paid for former laid off employees.[1]

In Minnesota the maximum experience tax rate is 8.9 percent. As a result, the maximum total UI tax rate is 9.0 to 9.5 percent, depending on the base rate in effect during a particular year[1].

[19] Office of Legislative Auditor, Financing Unemployment Insurance (January 2002), p. x-xi.

[20] Two types of tax rates are referred to in this document. First, we report the average tax on total wages which is the employer contribution due (incurred) during the year, divided by the total wages paid in covered employment (column 6 in Table 2). Since tax rates are not applied to total wages these rates are useful primarily for comparisons between States and years. The second tax rate is the nominal rate experienced by employers on their taxable wages—to describe this rate, we refer to the median rate, the rate paid by the "average" employer in the state.

consciously abandoned forward-funding, but that was the result. The flaws in the structure played out as the economy improved and effectively moved the state away from true forward funding.

**Table 3: Minnesota's UI Financing Overview, 1990--2002***

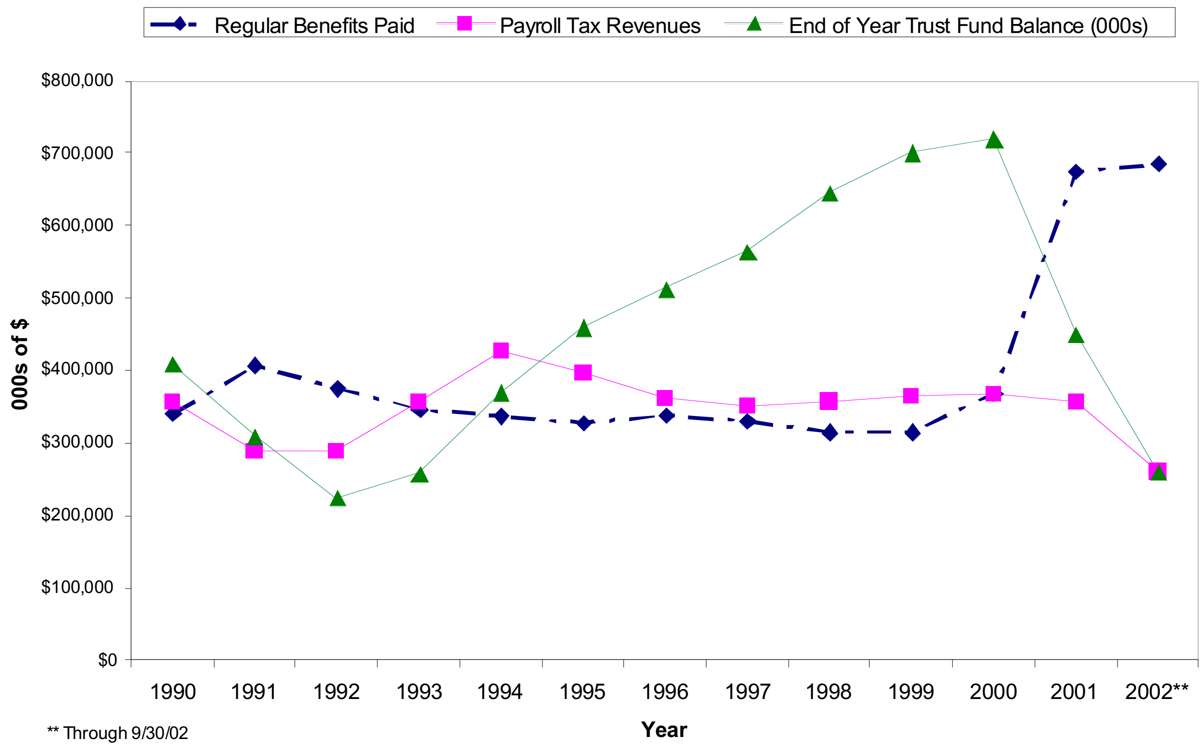
| Year | Regular Benefits Paid (000s) | Payroll Tax Revenues (000s) | End of Year Trust Fund Balance (000s) | Average Employer Tax Rate as Percent Total Wages |
|---|---|---|---|---|
| **1990** | $340,934 | $357,103 | $409,119 | 0.96% |
| **1991** | $407,859 | $288,550 | $309,473 | 0.72% |
| **1992** | $375,642 | $287,773 | $224,091 | 0.68% |
| **1993** | $347,284 | $357,145 | $257,584 | 0.86% |
| **1994** | $337,773 | $426,026 | $369,776 | 0.94% |
| **1995** | $328,442 | $398,020 | $459,621 | 0.79% |
| **1996** | $338,745 | $362,432 | $513,033 | 0.66% |
| **1997** | $330,522 | $351,950 | $564,628 | 0.60% |
| **1998** | $315,605 | $357,753 | $645,615 | 0.55% |
| **1999** | $315,605 | $364,382 | $700,857 | 0.51% |
| **2000** | $369,279 | $367,620 | $720,226 | 0.46% |
| **2001** | $675,388 | $356,352 | $450,503 | 0.43% |
| **2002** | $685,995 | $260,500 | $260,500 | 0.4%[21] |

*All figures from U.S. Department of Labor, Office of Workforce Security. 2002 figures are end of 2nd quarter 2002. Employer tax rate for 2002 calendar year estimated by U.S. Department of Labor, UIPL 35-02.

The 1987 legislation reinforced the trend in Minnesota's UI financing policies. Minnesota's system collects sufficient revenues to pay UI benefits in most years, but because of the financing structure the good times were no longer an opportunity to build a reserve for a downturn. Table 3 and Figure 1 show that in the 1990s Minnesota's UI taxes fell steadily while revenues roughly equaled benefit payments. In recession or near-recession years (like 1991, 1992, 2001, and 2002), benefit payments exceeded revenues. As a result, trust fund balances failed to rise high enough to avoid borrowing and federal interest charges during economic downturns.

[21] Tax rates were not available at the hundredth percentile for 2002.

**Figure 1 - Minnesota UI Taxes and Benefit Payments 1990-2002**



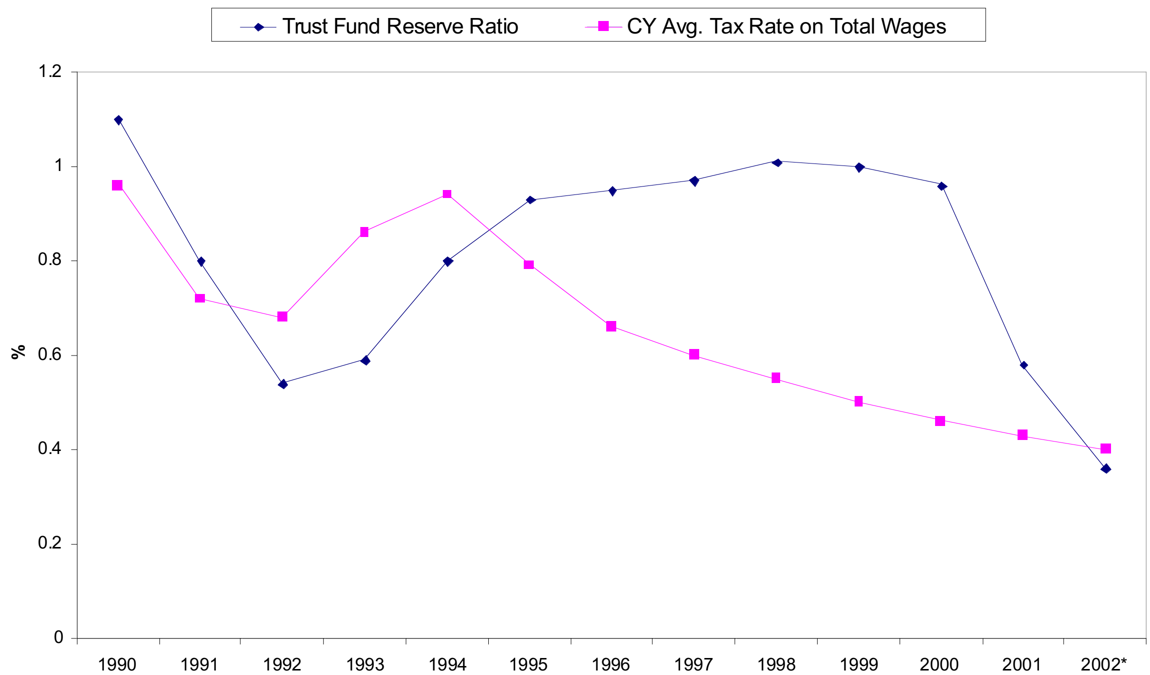

** Through 9/30/02

There is one main reason why Minnesota's trust fund must now borrow federal funds. Minnesota's UI financing policies keep trust fund balances too low because the triggers for increases to the base tax rate are tied to a fixed dollar amount, rather than to a percentage of total wages. In hindsight, it is easy to see that the trigger point set in 1987 ($300 million) was too low and has not kept pace with wage growth. In 1987 the average weekly wage in Minnesota was $390 and the average weekly UI benefit was $177. In 2002 average wages were around $710 and average benefits were $302. In other words, wages and benefits have roughly doubled in the intervening years, but the base tax rate triggers have remained fixed.

Moreover, by tracking growth in the trust fund reserves, we can see that the current financing structure failed to collect enough funds during the strong economic growth years of the late 1990s. By the end of 2000 the trust fund had reached $720 million, but even this higher balance was too low to prevent borrowing in a relatively mild recession.

To show how the trust fund relates to potential recession payouts, let's look at the reserve ratio, which compares the size of the state's trust fund to growth in the economy. The reserve ratio is a standard measure of any insurance system—the reserves compared to the risk being insured (in this case wages). Figure 1 illustrates the reserve ratio for Minnesota's UI system—the ratio of end of year trust fund reserves to the total wages in covered employment. In a "forward funding" system, such a ratio grows during good economic periods and provides the reserves needed to pay increased benefits during a recession. So, even though Minnesota's UI trust fund doubled in size from 1994 to 2000, the reserve ratio remained flat, fluctuating between 0.96 and 1.03. The decline in tax rates during this period is the cause of the stagnation in the reserve fund—with yearly contributions failing to keep pace with substantial wage growth.

**Figure 2 - Trust Fund Reserves Compared to UI Tax Rates, 1990-2002**




Source, U.S. Department of Labor, Office of Workforce Security, ETA 394 Handbook, Quarterly Data SummaryReserve Ratio, through 6/30/02 *Official Projection of Taxes

## B. Maintaining Adequate Benefit Levels to Support the Economic Stimulus Goals of UI

Minnesota's trust fund will borrow from the federal government to maintain UI benefit payments; and both employer experience and base tax rates will rise. When faced with financing challenges during a recession, less solvent states will be tempted to restrict their UI programs if additional tax increases are considered.[22] States with less solvent trust funds will have an incentive to cut benefits and limit eligibility for unemployed workers.

Minnesota is a relatively high wage state, so it pays higher UI benefits than lower-wage states like neighboring North and South Dakota. In the second quarter of 2002 (April-June 2002) average statewide weekly wages were $701.14 in Minnesota, and only $487.25 and $482.96 in North and South Dakota, respectively. Minnesota's wages ranked 13th of 53 UI jurisdictions, while average wages in North and South Dakota ranked 50th and 51st.

Average weekly UI benefits in Minnesota in 2002 was $302. The maximum weekly benefit for 2002 was $467. The absolute dollar amount of Minnesota's UI weekly benefits has increased over the years, but this growth reflected the state's increased wage levels. This is appropriate, since UI benefits insure the risk of lost wages and the growth in wages reflects the standard of living of Minnesota residents. Payment of adequate weekly UI benefits is essential to both the economic stimulus and wage replacement goals of unemployment insurance.

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[22] Wayne Vroman, <u>Topics in Unemployment Insurance Financing</u>, pp. 5-23.

**Table 4: UI Benefits and Wage Replacement (1980 to 2002)**

| Year | Average Weekly Benefit | Wage Replacement Rate* |
|---|---|---|
| **1980** | $117.72 | 44.4% |
| **1981** | $125.99 | 43.5% |
| **1982** | $137.08 | 43.8% |
| **1983** | $140.77 | 42.8% |
| **1984** | $146.15 | 42.4% |
| **1985** | $155.27 | 43.2% |
| **1986** | $168.82 | 45.0% |
| **1987** | $176.75 | 45.2% |
| **1988** | $181.31 | 44.1% |
| **1989** | $179.93 | 43.7% |
| **1990** | $183.93 | 42.9% |
| **1991** | $188.35 | 42.5% |
| **1992** | $192.13 | 41.0% |
| **1993** | $203.27 | 42.7% |
| **1994** | $210.96 | 43.1% |
| **1995** | $219.95 | 43.6% |
| **1996** | $223.21 | 42.7% |
| **1997** | $229.96 | 41.8% |
| **1998** | $242.54 | 41.8% |
| **1999** | $262.64 | 44.6% |
| **2000** | $275.99 | 43.6% |
| **2001** | $293.05 | 45.0% |
| **2002** | $301.55 | 44.3% |

*Wage Replacement Rate is Minnesota's average weekly UI benefit divided into the statewide average weekly wage.
**Sources:** U.S. Department of Labor, UI Data Handbook No. 394 (annual figures for 1980 to 1988); Minnesota Department of Economic Security, ETA 5159 Reports (1989 – 2002).

As a higher wage state, Minnesota should and does provide higher weekly UI benefits compared to some surrounding states, and especially compared to low-wage states in the South and Southwest. Current UI weekly benefit levels in Minnesota have kept pace with increases in the cost of living for many years. UI benefit amounts are adjusted annually to reflect any increases in statewide wages. In essence, higher than average benefits are only a problem if high wages are a problem.

Reducing UI benefits would be a foolish response and would hurt Minnesota's jobless workers and the state's economy. The adequate benefits provided by the UI system have been a critical asset to the state's economy over the past 2 years. Minnesota communities need adequate UI benefits to replace the purchasing power lost when well-paid workers lose their jobs.

Upon reflection, the arguments for pay as you go financing look more like rationalizations for politically popular tax reductions than like serious economic analysis. A less solvent state UI trust fund also gives policy-makers a rationale for not improving UI benefit levels or program eligibility. Most important, pay as you go financing undercuts the economic stimulus impact of UI, since it raises taxes while unemployment is high. Perversely, pay as you go financing stimulates the economy with lower taxes while the economy is good, then raises taxes when the economy falters. Worse still, pay as you go financing creates pressure for UI benefit restrictions in the event that UI solvency reaches less than desirable levels.[23] In this case, not only would UI payroll taxes increase, but UI benefits would be cut during a recession—a double whammy on a state's economy and its unemployed workers.

## IV. Conclusion and Recommendations

As we show in table 3, Minnesota's UI tax system over the 1990s produced significant overall UI tax reductions. The higher UI taxes we have already seen in 2003, like those we will see in future years, result from the state's decision to abandon adequate forward financing, which in turn led to UI tax reductions during the 90s. These reductions depleted our trust fund reserves, making it impossible to properly finance UI claims during what many observers term a "mild recession." Minnesota also lost hundreds of millions of dollars in federal interest payments over the 90s, funds that Minnesota's employers will now be forced to replace with UI payroll tax dollars.

Given the importance of ensuring that UI programs protect the economic security of unemployed workers and stimulate our economy during recessions, Minnesota needs to shift to forward financing of its UI program. The solvency triggers adopted in 1987 should be raised significantly and tied to a percentage of total wages, rather than to a fixed dollar amount. The minimum tax should be raised from its current level of one-tenth percent. Finally, a state solvency tax should be maintained to reduce future borrowing from the federal government and collect funds to repay federal interest charges that Minnesota faces in November 2003. These steps are admittedly distasteful, but they are a consequence of ill-advised policy decisions taken in 1987 and insufficient consideration of UI trust fund solvency in the intervening years.

Every state's UI program is a combination of history and economics arising from political compromises and practical considerations. As we have shown, Minnesota's UI program provides substantial help to our economy and our laid off workers and their communities. For these reasons, Minnesota's UI program deserves the support of its public officials, citizens, and business community.

***All figures cited in this report are from U.S. Department of Labor, Office of Workforce Security or Minnesota Department of Economic Security.***

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[23] Vroman, *supra*, Topics in Unemployment Insurance Financing, pp. 54-61.