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Falling Into the Same Trap Twice: Understanding Unemployment Insurance Financing and Trust Fund Solvency in Massachusetts

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Executive Summary

- Legislation has put lower tax rate schedules into effect for nine of the ten years between 1994 through 2003, reducing unemployment insurance (UI) taxes by about $1.69 billion dollars over these ten years.

- As a result of the artificially low rate schedules in effect between 1994 and 2003, and higher benefit claims due to the economic slowdown since 2001, Massachusetts now faces a dwindling trust fund, higher UI payroll taxes and potential federal borrowing.

- The result of interference with the rate schedules has been falling UI payroll tax rates over the last ten years, with average UI taxes falling by more than half between 1994 and 2002. The average tax rate on total wages in calendar year 2002 reached 0.67 percent in Massachusetts. In other words, of total wages and salaries paid in the state, UI payroll taxes amounted to two-thirds of a penny for every dollar paid in wages.

- While employers in Massachusetts enjoyed $1.69 billion in tax reductions and falling tax rates as a result of legislation blocking higher rate schedules from taking effect, the state's trust fund lost from between $300 million and $970 million in federal interest earnings between 1994 and 2003.

- In order to keep lower tax schedules in effect, Massachusetts did not build trust fund solvency levels after 1994. At its peak level at the end of 2000, the Massachusetts trust fund was less prepared for recession in terms of the accepted measures of solvency than it was in 1988 before the early 90s recession that caused significant federal borrowing by Massachusetts.

- By adopting lower rate schedules, Massachusetts has fallen into what we call the "low tax/low trust fund trap." Massachusetts has for practical purposes traded lower taxes in the economic good times of the late 1990s for higher taxes in 2004 and coming years. A similar situation was present in the early 1990s recession. The state has fallen into the same trap twice.

- Massachusetts should return to forward funding of its UI trust fund. Forward funding provides a solvent UI trust fund enabling a state to ride through moderate recessions without federal borrowing or significant tax increases. Forward funding means that federal interest payments on trust fund balances pay for higher proportions of UI benefits than happens under a low tax/low trust fund policy.

- A higher taxable wage base, indexing of the taxable wage base, and permitting statutory tax schedules to work as intended will restore forward funding of the Commonwealth's UI trust fund. By taking these measures, Massachusetts can avoid the low tax/low trust fund trap in the next economic downturn.

Falling into the Same Trap Twice:
Understanding Unemployment Insurance Financing and Trust Fund Solvency in Massachusetts

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Summary

Massachusetts once again faces a crisis in financing its unemployment insurance program. Current proposals offer combinations of higher payroll taxes and sacrifices by jobless workers as solutions for this financing crisis. For the most part, these "solutions" ignore the underlying reasons why Massachusetts is facing another unemployment insurance financing crisis only ten years after its trust fund last borrowed hundreds of millions of dollars from the federal government. Understanding the history and policies that have led Massachusetts to again have insufficient trust fund reserves to ride out a fairly mild recession is essential, in our view, to developing real solutions to unemployment insurance trust fund financing in Massachusetts.

In the early 1990s recession, Massachusetts was forced to borrow federal funds in order bail out its unemployment insurance (UI) trust fund. At that time, the legislature raised the taxable wage base to its current level of $10,800 and made other changes in taxes and benefits. In the intervening years, the Massachusetts legislature, at the urging of the business community and then-serving Governors, took repeated actions to ensure that UI payroll taxes were kept artificially low. In nine of the last ten years, the Legislature kept statutory rate schedules from increasing taxes to build trust fund reserves. As a result, UI tax rates did not adjust as intended by the statutory tax schedules and UI trust fund balances were reduced nearly $1.7 billion below intended levels. In short, Massachusetts fell into what we call a "low tax/low trust fund trap."

The major causes of the state's trust fund crisis are the tax reductions from 1994-2002 and higher UI claims that have accompanied the economic downturn and job slump that started in early 2001. So long as the Commonwealth's economy was booming, reduced UI payroll tax revenues were sufficient to pay the resulting low levels of UI claims, but once higher UI claims hit in 2001, trust fund reserves rapidly fell. As a result of the artificially low tax levels of the 90s and higher claims since 2001, Massachusetts now faces higher UI payroll taxes and potential federal borrowing.

Interestingly, while the Legislature repeatedly intervened to keep UI payroll taxes low between 1994-2003, these tax changes were not "balanced" with corresponding expansions in UI eligibility or benefits. Now, with trust fund balance projections plunging, some proposals for addressing UI solvency include sacrifices by jobless workers to "balance" increased UI payroll taxes. Given that jobless workers did not share corresponding benefit increases when employers got tax schedule reductions throughout the 1990s, appeals for "balance" when addressing the consequences of those tax reductions in 2004 are not rooted in fairness or reality.

Recommendations

This report calls for three essential measures to get Massachusetts' out of its low tax/low trust fund trap and to solve the state's UI financing crisis.

- First, the statewide taxable wage base should be significantly increased. This will improve the financial foundation for UI payroll taxes, significantly increase revenue in the short run, and gradually lower payroll tax rates in the longer run.

- Second, the increased taxable wage base should be indexed to the growth in statewide wages so that the financing structure will keep pace with future growth in wages. Indexing the taxable wage base ensures that the financial foundation for UI funding grows as wages and the economy grow.

- Third, the Legislature must stop interfering with the operation of the statutory UI tax schedules so that forward financing of the Commonwealth's UI program can resume. This will make tax increases and federal borrowing less likely in future recessions and raise the proportion of UI benefit costs that are paid from federal interest rather than payroll taxes.

This briefing paper provides a history and overview of UI financing in Massachusetts. While somewhat arcane, an understanding of UI financing and trust fund solvency is essential in deciding what steps are properly required in order for Massachusetts to avoid falling into the low tax/low trust fund trap once again.

ABCs of UI Financing and Tax Rates

Unemployment insurance programs are essentially self-financing, in the sense that UI benefits are financed through employer UI payroll taxes that are retained in a state UI trust fund.[1] UI taxes impact employers and our economy, but are separate from the overall state budget and general revenue taxes. States' UI trust funds are legally dedicated under state and federal law solely to UI benefit payments. A separate federal payroll tax (Federal Unemployment Tax Act, or FUTA) funds the administration of state UI agencies as well as federal functions, including federal extensions and the federal loan fund.[2] State trust funds are retained in the U.S. Treasury until they are used to pay benefits. The federal treasury pays federal interest on state UI reserves. States pay identical interest rates to the federal treasury if required to borrow interest-bearing debt when their state UI trust funds are inadequate to keep up with UI benefit payments. (In some circumstances, interest-free "cash flow" borrowing can occur on a shorter-term basis.)[3]

No employer likes paying taxes, and no tax is low enough in the view of most employers. While recognizing this viewpoint, UI payroll tax rates in most cases are not significant in terms of overall labor costs or tax burdens on employers.

To begin, UI taxes are imposed on a "taxable wage base," rather than on total wages. In Massachusetts, the taxable wage base has been $10,800 since 1992. Employers pay UI taxes only on the first $10,800 of wages paid to any employee in a calendar year. In Massachusetts, the 2003 maximum tax rate is 7.23 percent of taxable wages and the minimum tax rate is 1.33 percent. On the current taxable wage base of $10,800, this translates to a maximum state UI payroll tax of $780 for every employee earning $10,800 or more, and as low as $143 for employees of firms paying a minimum tax rate.

While UI taxes are imposed on a limited taxable wage base, comparing UI taxes to total wages is a more accurate means of comparing UI taxes to overall employer labor costs. The average tax rate on total (as opposed to taxable) wages for CY 2002 was 0.67 percent in Massachusetts, according to the U.S. Department of Labor. ***This means that of total wages and salaries paid in the state, UI payroll taxes amounted to two-thirds of a penny for every dollar paid in wages in 2002***. The Massachusetts' average UI tax in 2002 was ranked 19th out of all the states in the nation.

In Massachusetts, the overall UI payroll tax rate has two components for private employers, the "experience rate" and the "tax schedule."[4] These two components make up a payroll tax rate that applies to covered private employers. The experience rate for any upcoming year is calculated by dividing an employer's accumulated trust fund account balance of payroll contributions on September 30 by that employer's total wages. This establishes a "reserve percentage" for that employer, and each range of reserve percentages has a contribution rate then assigned to the employer for the coming year by law. Since the employer's account balance falls as UI benefits are paid to laid-off employees of the firm, payments of UI claims will result in a higher experience rate in future years.[5]

The second component determining the overall UI payroll tax rate is the rate schedule in effect. Massachusetts has a range of rate schedules in its UI rate tables, with rate schedules designed to automatically increase taxes as trust fund balances fall in relation to covered wages (trust fund as a percent of total wages). The current rate schedule has 45 rows and eight columns. [6]

The rate schedules are designed to automatically produce more tax revenues to ensure that UI trust fund balances are sufficient to pay future UI claims. The degree of tax increases called for by the higher rate schedules depends upon the degree to which the trust fund falls as a percentage of wages. In other words, a more insolvent trust fund leads to higher rate schedules while a more solvent fund results in lower rate schedules. A large majority of states uses a rate schedule or other method to adjust tax rates in conjunction with increases in their UI trust fund reserve levels.

Table 1: Average UI Tax Rates in Massachusetts, 1993-2003[1]

Year	CY Avg. Tax Rate on Total Wages
1993	1.61
1994	1.53
1995	1.43
1996	1.31
1997	1.30
1998	0.94
1999	0.72
2000	0.68
2001	0.66
2002	0.67
2003 (est.)	0.8

The experience rate combined with the tax schedule in effect for that year determines each individual employer's tax rate. This rate is then applied to the taxable wage base for every covered employee. As UI claims rise, the payroll tax rates are designed to adjust in two ways. The impact on individual firms is captured through each firm's experience rate while the rate schedule reacts to the overall trust fund level.

Rather than permitting the statutory tax schedules to operate as designed, the Massachusetts Legislature has consistently intervened in order to keep a lower tax schedule in effect. The result has been falling UI payroll tax rates over the last ten years, as shown by Table 1.

From their 1993 peak of 1.61 percent of total wages (reached after the recession and federal borrowing of the early 90s), average UI taxes fell by more than half in Massachusetts by 2002 (reaching 0.67 percent). Lower UI taxes are going to end now, as recent increased benefit claims levels and past tax breaks for employers have combined to force the state to increase revenues to maintain UI trust fund solvency.

The Senate Committee on Post Audit and Oversight's April 2003 report found that the Legislature lowered the tax schedule nine times in the ten years between 1994 through 2003. According to the report, these legislative interventions saved employers about $1.69 billion dollars during these ten years.[7] In putting lower tax schedules into effect, the Legislature acted at the request of many business groups and then-serving Governors. However, as a result of these actions, the trust fund did not grow as intended by law. As we will see, UI tax revenues covered current UI benefits, but did not build trust fund reserves to levels sufficient to carry the Massachusetts' UI program through the current downturn.

While employers undoubtedly thought they were advantaged by legislative interference with the statutory tax rate schedules between 1994 and 2003, there are serious shortcomings for states that fail to attend to trust fund solvency issues during more favorable economic periods. We will examine these shortcomings after first discussing how to properly assess state UI trust fund solvency.

For the ten years of 1994 through 2003, the Legislature put lower-than-called-for tax schedules in place for nine years, reducing UI trust fund contributions by $1.69 billion dollars.

ABCs of UI Trust Fund Solvency

"Solvency" concerns the assessment of the adequacy of accumulated UI trust fund reserves. Solvency is important in determining the overall financial health of UI programs. Less solvent states have incentives to adopt less generous benefits and more restrictive UI program eligibility. When faced with financial challenges during a recession, less solvent states are more likely to be tempted to restrict their UI programs in conjunction with any tax increases they are forced to impose on their employers.[8] For these reasons, adequate UI trust fund solvency is a significant issue for protecting the interests of unemployed workers and the future financial health of UI programs.

Total trust fund dollar amounts provide little or no valuable information in assessing trust fund solvency. A billion dollar trust fund balance in New Hampshire looks very different than a billion dollars in Massachusetts because the size of their respective state economies varies considerably, as does the potential wage loss being insured. Similarly, a balance of $750 million in 1988 in Massachusetts is not the same as a $750 million dollar balance in 2003. Growth in wages over time makes benefit amounts higher and growth in employment increases the number of potential UI claimants in a downturn.

Two common measures of trust fund solvency provide a means of judging the adequacy of reserves. These two measures are called "cost multiples" and "reserve ratios." The "average high cost multiple" (or AHCM) expresses the sufficiency of a state's trust fund balance to pay benefits at levels equivalent to average benefit payments a state experienced during past recessions without taking any current revenues into account. A state's AHCM is calculated based upon the average of the three 12-month high payment periods (recessions). In other words, an AHCM of 1.0 means that a state has reserves sufficient to pay benefits for 1 year of an average recession without taking any revenues into account. An AHCM of 0.5 translates to 6 months' reserves.

AHCMs are a fairly recent modification of "high cost multiples" (or HCMs). HCMs were the traditional trust fund solvency measure, originally derived from the life insurance industry. HCMs look at the historic highest payment levels over 12 calendar months and compare current reserves to that amount (both the high cost rate and current reserves are expressed as a ratio to total wages to reflect growth in the economy).

AHCMs are generally, but not always, easier targets for state trust funds to meet, since they average the three highest payment levels.

In the late 1950s, an HCM of 1.5 (or 18 months of reserves) was widely considered desirable. The Advisory Council on Unemployment Compensation, a bipartisan federal panel convened in the early 90s, recommended that the federal government adopt an AHCM of 1.0 as a goal for states' trust funds[9] While no federal solvency standard has ever been formally adopted, an AHCM of 1.0 is a generally accepted measure of solvency for trust funds during non-recessionary periods.

The second common measure of UI solvency is the "reserve ratio," which simply is the trust fund balance as a percentage of total wages. This measure compares the size of the trust fund to the wages that are potentially insured by the UI program. While AHCMs look to history as a basis for judging solvency, reserve ratios use the relationship between trust fund balances and the state's current payroll to assess the adequacy of reserves. Unlike AHCMs, there is no accepted reserve ratio that reflects an adequate level of solvency.

Table 2 shows that Massachusetts did not seriously address UI trust fund solvency following its financing crisis in the early 90s. For the most part, state officials focused on the dollar amount in the trust fund during the late 90s, rather than trying to meet traditional measures of solvency. The trust fund reached an AHCM near 1.0 between 1998 and 2000, but keeping lower tax schedules in place kept the Massachusetts trust fund from building reserves sufficient to ride through the current economic downturn without requiring significant tax increases or sacrifices by jobless workers.

Table 2: Mass. Trust Fund Solvency, 1990-2002

Year	Average High Cost Multiple	Trust Fund Reserve Ratio
1990	0.24	0.6
1991	-0.16	0
1992	-0.24	0
1993	-0.07	0
1994	0.11	0.26
1995	0.36	0.7
1996	0.63	1.13
1997	0.93	1.63
1998	1.06	1.86
1999	1.03	1.81
2000	0.98	2.34
2001	0.80	2.3
2002	0.44	1.03

In order to keep lower tax schedules in effect, Massachusetts did not build solvency levels following the end of borrowing and insolvency beginning in 1994. ***Massachusetts has for practical purposes traded lower taxes in the economic good times of the late 1990s for higher taxes in 2004 and coming years.***

Recent History of Massachusetts UI Trust Fund Financing

If past history is any indication, the ABCs of UI financing and solvency are either not understood or not accepted in Massachusetts. The lessons of past recessions have been ignored along with accepted UI financing policy. As a result, the state is now faced with a narrow range of alternatives, with none of them very palatable. To understand the reasons for the current dilemmas faced in Massachusetts, a review of recent trust fund financing history is needed.

In the early 1990s, Massachusetts was forced to borrow from the federal government because its UI trust fund was unable to finance UI benefit payments. Massachusetts had loans totaling $234 million at the end of 1991, $380 million in 1992, and $116 million in 1993. In 1992, the legislature addressed UI financing by adopting a higher taxable wage base (initially increased to $10,800, set to increase to $13,000 but reduced back to $10,800) and revising its tax rate schedules. Beginning in 1994, as the trust fund rose out of insolvency, the legislature passed the first of a series of almost-annual measures to keep the statutory rate schedules from adjusting upwards to impose higher UI payroll taxes. UI payroll taxes fell steadily after 1993 as shown in Table 1.

Legislative intervention in the rate schedules kept taxes lower, but did not build trust fund balances in the 1990s sufficient to carry Massachusetts through the current recession and job slump. Table 3 shows the benefit payments, tax revenues, and end of year trust fund balances in Massachusetts between 1990 and 2002. These annual figures show how Massachusetts fell into the same UI financial trap so quickly after climbing out of the early 90s insolvency in 1994.

Table 3: Massachusetts UI Financial Data 1990-2002

Year	Regular Benefits Paid	Payroll Taxes	Trust Fund Balance (000s)
1990	$1,090,630	$505,760	$381,795
1991	$1,232,369	$635,885	$0
1992	$969,936	$839,046	$0
1993	$761,027	$998,697	$0
1994	$786,759	$1,068,809	$184,933
1995	$731,615	$1,074,938	$527,273
1996	$719,980	$1,060,065	$914,631
1997	$686,083	$1,145,793	$1,446,164
1998	$694,415	$945,832	$1,802,999
1999	$776,857	$785,001	$1,921,621
2000	$821,829	$745,331	$2,131,041
2001	$1,319,930	$822,391	$1,770,487
2002	$2,000,313	$990,023	$919,995

To summarize Table 3, gradually lower tax revenues roughly equaling steady UI benefit payments produced little trust fund growth during the late 1990s. In 1997, the only year between 1994 and 2003 in which the Legislature did not put a lower tax schedule into effect, the trust fund balance grew significantly. Beginning in 2000, benefit payments exceeded revenue and trust fund balances declined. In effect, the state repeatedly chose lower UI taxes over trust fund growth and this is what we refer to in this paper as the low tax/low trust fund trap.

Table 3 also shows that a rapid increase in UI claims caused by the economic downturn is another major reason why the trust fund faces insolvency. Unemployment in Massachusetts was only 2.6% in December 2000. At that time, Massachusetts's UI trust fund had a seemingly large balance of $2.131 billion. As unemployment rose, payments of benefits jumped from $821 million in 2000 to $2 billion in 2002. The state's trust fund balance made up the difference between current UI payroll tax revenues and increased UI benefit payments, but the balance was quickly reduced as benefit payments greatly exceeded tax revenues. By December 2002 Massachusetts's trust fund balance had fallen to $919 million and the balance fell to $490 million by June 30, 2003, as UI claims levels continued at high levels and taxes were held lower by 2002 legislation.

The core reasons for the current UI financing shortfall include the tax cuts from 1994-2002 combined with the rapid increase in claims beginning with the economic downturn in early 2001. The impact of reduced revenues from 1994 through 2003 combined with higher claims in 2001 and 2002

quickly reduced the state's trust fund balance. Most observers now expect higher taxes for several years to address the revenue shortfalls.

While higher current and future UI claims levels are going to result in future payroll tax increases in Massachusetts, it is important to recognize that this is part of the design of UI financing. This normal response to rising UI claims is going to be greatly increased in Massachusetts because employers advocated and obtained legislative relief to keep higher tax schedules from going into effect throughout the 1990s. These tax schedule increases were designed to automatically provide trust fund reserves to pay higher benefit claims in the future, but since they were blocked by legislation in economic good times, higher taxes in the coming years are the predictable consequences.

While the Legislature repeatedly intervened to keep UI payroll taxes low between 1994-2003, these tax changes were not "balanced" with corresponding expansions in UI eligibility or benefits. Now, with trust fund balance projections plunging, some proposals for addressing UI solvency include sacrifices by jobless workers to "balance" increased UI payroll taxes. Given that jobless workers did not share corresponding benefit increases when employers got tax schedule reductions throughout the 1990s, appeals for "balance" when addressing the consequences of those tax reductions in 2004 are not rooted in fairness or reality.

In short, the current UI financing crisis has two major causes. First, when the economy was good and trust fund balances should have been building, the Legislature and Governors repeatedly gave in to employer groups' pleas to keep UI taxes down. Second, the economic downturn that began in early 2001 and has continued to the present doubled benefit payment levels. As a result, the trust fund's reserves were too low to carry the state's UI program through a relatively mild recession.

Forgotten Lessons of the Early 90s Recession

By examining the trust fund in the pre-recession times of the late 1980s, it's possible to review the trust fund's finances through the two most recent economic downturns. This review illustrates that Massachusetts ignored obvious lessons from the early 90s recession when restraining its tax rate schedules beginning in 1994. In 1988, the Massachusetts UI trust fund balance was $1.133 billion dollars. The high cost multiple was 0.78 and the trust fund balance was 1.84 percent of total wages (reserve ratio). By 1991, the trust fund was in debt and Massachusetts was borrowing from the federal government to maintain benefit payments.

At its peak level at the end of 2000, the Massachusetts UI trust fund was less solvent than it had been in 1988– before the early 90s recession that resulted in significant federal borrowing.

During the 1990s, representatives of the business community successfully argued that trust fund balances were large enough for the state to afford tax cuts, and the legislature repeatedly prevented rate schedule adjustments that would have built UI trust fund reserves. The trust fund balance peaked at the end of 2000 when reserves were $2.131 billion. Even though this was a record balance of trust fund dollars, Massachusetts had an HCM of only 0.55 and its reserve ratio was 1.76 percent. In other words, at its peak at the end of 2000, the Massachusetts trust fund was less solvent than it had been in 1988 before the early 90s recession that resulted in significant federal borrowing.

Acting again on the entreaties of employer groups, the legislature again enacted laws in 2000 and 2001 that kept the rate schedule on schedule B, rather than schedule D or schedule F in 2002 and 2003, respectively. In December of 2002, the rate was again frozen at schedule B. Overall, other than in 1997

(when schedule E was in effect), the legislature imposed a lower rate schedule in each of the ten years beginning in 1994 and continuing through 2003.

The pattern of UI payroll tax reductions starting so soon after the state's federal borrowing of 1991 to 1993 demonstrates that low taxes are a political virtue in the eyes of public officials and business groups regardless of the deleterious impact on the trust fund. The risks of higher taxes and future borrowing are perceived as remote and insignificant when compared with the benefit of immediate tax reductions. The costs and benefits of the low tax/low trust fund policy are not fully appreciated, however, because the loss of federal interest earnings on the state's trust fund has never been properly considered.

Lost Federal Interest-A Hidden Cost of Bad Policy

An additional cost of the low tax/low trust fund trap is lost federal interest on the state's trust fund. While the Massachusetts' trust fund earned $743 million in federal interest in between 1994 and 2002, the interest paid was lower than otherwise would have been earned if the trust fund balance had been higher. According to our calculations, illustrated in Table 4, Massachusetts lost hundreds of millions of dollars in federal interest between 1994 and 2002 by providing tax cuts to employers and not permitting the trust fund to reach an average-sized high cost multiple. ***If Massachusetts had just maintained a trust fund balance with an average high cost multiple equal to the national HCM in each of the years between 1994 and 2002, its trust fund would have earned an added $300 million in federal interest***. And, if Massachusetts had maintained a trust fund balance equal to a high cost multiple of 1.0 (admittedly a pretty big trust fund), it would have earned $970 million in additional federal interest over this period.

Another way to look at this estimated lost federal interest is to see it as the lost interest on the $1.69 billion is lower taxes paid by Massachusetts employers due to the legislated reductions in tax schedules between 1994 and 2002.

In summary, between $300 million and $970 million in lost federal interest will now be made up by employer payroll tax collections (and perhaps by borrowing and paying federal interest on trust fund loans). Under some legislative proposals, jobless workers will be asked to make up for some of this lost federal interest through tighter UI eligibility standards and reduced benefit entitlements. Lost federal interest is a significant, if largely unrecognized, cost of the state's failed policy of keeping trust fund balances low in order to give tax relief to employers after 1994.

Federal Reed Act Funds-Another Lost Opportunity

In March 2002 federal legislation providing for temporary extensions of UI benefits was signed by President Bush. The Temporary Emergency Unemployment Compensation program arose from this legislation, and TEUC has provided federally financed benefit extensions that have been renewed by Congress on two occasions since. A less well-known aspect of this legislation was a special Congressionally mandated transfer of $8 billion from federal trust funds to state UI trust funds. This transfer of federal funds was called a "Reed Act distribution," a reference to mid-1950s legislation that provides for transfer of federal UI trust fund balances to state UI trust funds under certain circumstances.[10]

Massachusetts received $193.6 million for its share of the 2002 Reed Act distribution. These federal funds were deposited directly in the state's trust fund in March 2002. Unlike state UI payroll tax revenues, which are legally dedicated solely to payment of UI benefits, Reed Act funds were potentially available for appropriation for administration of UI, employment services, and one-stop programs, as well as use for expanding UI eligibility and benefit extensions. Because its trust fund balance was insufficient to meet

expected benefit obligations in Massachusetts, nearly all Reed Act funds were simply absorbed into the state's trust fund. (The state did make a small 2002 appropriation ($2.425 million) of Reed Act funds for aspects of its one-stop program.) The remaining $191 million in Reed Act funds were effectively used to offset employer UI taxes in 2002.

These Reed Act funds represent another lost opportunity for the Massachusetts UI program, in that the flexibility to spend Reed Act funds for administrative needs or improved UI eligibility was overridden by the financial exigencies of the trust fund solvency situation. An example is furnished by neighboring New Hampshire, where a 13-week state extension program was created using Reed Act funds.

Forward Funding vs. Flexible Financing

UI programs were intended by their designers to accumulate reserves in trust funds in order to provide advance funding of higher UI claims during economic downturns. The level of state UI trust fund reserves overall as a percentage of payrolls peaked in the decade after World War II. In general, state UI trust funds have not kept pace with the growth in payrolls since that time, although most states still follow a policy of forward funding of estimated future claims.

The recessions of the 1970s and 1980s provoked widespread borrowing by state trust funds, with the early 90s recession requiring borrowing by a smaller group of states, including Massachusetts. The mid- and late- 90s found state UI payroll taxes falling as a result of lower UI claims in combination with explicit legislation lowering UI payroll taxes in over half the states, including Massachusetts. As a result, the 90s closed with UI payroll taxes at their lowest levels in the history of the UI program in 2000, reaching 0.53 percent of total payrolls nationally. In addition, while overall levels of state trust funds were sufficient to sustain rising UI claims in 2001 and 2002, Massachusetts and a number of states entered the downturn with lower than recommended reserves.

The great majority of states currently facing serious UI financial challenges are states that abandoned traditional forward financing or funding during the late 1980s and 1990s. The rationale for this shift from traditional forward funding was provided by the closely-related philosophies of "pay as you go" or "flexible financing." These rationales were advocated beginning in the late 1980s as an alternative to traditional forward funding of state UI trust funds. Under forward funding, states build up UI trust fund balances during economic recoveries so that they can ride through recessions without significantly increasing UI payroll taxes or borrowing loans from the federal government.

Some states explicitly abandoned forward funding and adopted pay-as-you go financing, including Illinois, Pennsylvania, Texas, Minnesota, and New York. Other states, including Kansas, North Carolina and Michigan, engaged in aggressive UI payroll tax cutting in the 1990s without explicitly giving up on forward funding. Massachusetts belongs in this second group of states, since at no point have state policymakers openly abandoned the concept of forward financing of the state's trust fund, although the Legislature's frequent interference with tax schedules have effectively abandoned forward financing since 1994.

In our view, traditional forward funding of UI has significant advantages. Since tax increases and benefit cuts further contract economic activity, states that have abandoned forward financing, whether consciously or not, have undermined the counter-cyclical economic impact of UI.[11] In addition, pay-as-you go states forego millions in federal interest on trust fund balances during good times and must face federal borrowing to maintain benefits as well as federal interest payments during recessions. In addition, states with solvency concerns face pressures to make cuts on the benefits side of the UI cost equation as well. Just as

tax increases during a recession are bad policy, benefit cuts or freezes undercut the positive economic impact of UI programs.

In Massachusetts, the Legislature's interference in tax rate schedules furnishes somewhat unique variant of flexible financing. The statutory tax schedules in place are designed to provide higher tax rates when the trust fund's reserve levels are lower. However, since the early 90s recession, the Legislature and then-sitting Governors have consistently prevented higher schedules from going into effect by blocking the operation of the statutory tax schedules in 9 of the last 10 years. This has prevented the tax rate schedules from raising UI taxes and building trust fund balances as intended. As a result, lower tax rates applied during the prosperous 90s and trust fund balances did not build to levels sufficient to carry Massachusetts through the recession and present job slump.

Instead of building trust fund reserves, employers enjoyed $1.69 billion in tax reductions between 1994 and 2003. When combined with the lost federal interest due to reduced trust fund balances since 1994, the Massachusetts UI trust fund balance is between $2 billion and $3 billion lower in 2003 than it would have been if the Legislature had adhered to tax schedules in existing law (all other things being equal, of course). The impact of this lost trust fund revenue will only be exacerbated if Massachusetts must pay federal interest on trust fund loans in coming years. Instead of getting federal interest payments on trust fund balances, the state will be making federal interest payments on loans. ***The fact that Massachusetts is again facing UI insolvency, less than 10 years after its trust fund last borrowed federal loans, is a testament to the literal and figurative bankruptcy of the state's UI financing policies***.

There are two main causes of the state's UI trust fund solvency crisis. The first is clearly the state's repeated actions preventing its tax schedules from increasing—totaling $1.69 billion in tax reductions—between 1994 and 2003. These tax cuts in turn cost Massachusetts a conservatively estimated $300 million in lost federal interest between 1994 and 2002. Second, increased unemployment led to a doubling of UI claims and significantly higher UI benefits costs. Compared to these major cost factors, specific features of the Massachusetts UI program are simply of insufficient magnitude to warrant an accurate description as "cost drivers."

Freezing or cutting UI benefit levels, or restricting eligibility for certain groups of jobless workers, as advocated by some, undoubtedly is aiming at the wrong target. Benefit increases and eligibility expansions did not "balance" the UI tax schedule reductions made since 1994, so calls for equality of sacrifice and balance when restoring trust fund solvency in 2004 ring hollow. In addition, the degree of benefit cuts required to make a significant contribution to restoring solvency makes them politically unacceptable. For example, even if UI benefit costs were reduced by half during 2002, UI payroll tax revenue still would not have covered that year's benefit payments. See Table 3.

To the degree benefit cuts and eligibility restrictions are on the table in Massachusetts, we would characterize them more as sacrificial lambs than substantive policy responses to the solvency crisis. While organized employer groups will try to avoid facing the facts and seek to shift some of the financial burden to jobless workers, there is no question that bad UI financing decisions advocated by employer groups during the 1990s are coming home to roost.

Regardless of whether Massachusetts avoids interest-bearing federal loans in coming years, employers must now effectively repay those 1994 to 2003 payroll tax reductions, as well as making up the federal interest that was lost over those years while paying ongoing UI benefit payments. The important question

for 2004 is whether Massachusetts will learn the lessons of the last two recessions or once again fall into the low tax/low trust fund trap. Simply put, significantly higher UI taxes in Massachusetts are necessary, and–given the role tax reductions and the resulting losses of federal interest have played in creating insolvency–fair policies addressing the state's current UI financing dilemma.

Key Steps to Restore Sound UI Financing in Massachusetts

Given the history and causes of the state's UI financing crisis, there are three key steps that Massachusetts should take to resolve its current situation and avoid similar miscues in the future. These steps should be taken in concert to resolve the current financing crisis and avoid again falling into the low tax/low trust fund trap. In addition, the state's employers, rather than federal interest, will pay a higher share of future UI benefits.

In short, given the significant costs of remaining in low tax/low trust fund trap, Massachusetts needs to get back to forward funding of its UI program. Our recommendations address both the immediate crisis as well as restoring sound UI financing in Massachusetts over the longer term.

1. Significantly Increase UI Taxable Wage Base

The first key step toward improved UI financing in Massachusetts is a significant increase in the state taxable wage base. Higher taxable wage bases improve the financial foundation for UI payroll taxes, increase revenue in the short run, and gradually lower rates in the longer run. Massachusetts has a taxable wage base of $10,800. A significant minority of states have raised their taxable wage bases, with nine states above $20,000 (Alaska, Hawaii, Idaho, Minnesota, Nevada, New Jersey, Oregon, Utah, and Washington).

With the exception of Minnesota (which has flexible financing), all states with taxable wage bases above $20,000 are weathering the current downturn without serious solvency concerns, and certainly all of the states with higher taxable wage based are doing better than pay as you go states like Illinois, Pennsylvania, New York, and Texas. The better-than-average financial status of states with higher taxable wage bases is reasonable, since lower taxable wage bases place UI financing on a narrower basis. In combination with maximum tax rates, taxable wage bases determine how quickly a state's trust fund can respond to increased UI claims during downturns. An ability to recover revenue promptly in response to higher UI claims increases a state's ability to avoid or limit the size and duration of federal loans or to repay loans.

Raising the taxable wage base will produce significant revenue in the first year or two during which it is effective. This will have the advantage of reducing or avoiding federal loans and their potential interest charges.

In the longer term, collecting UI payroll taxes on a higher taxable wage base should produce lower overall tax rates. This takes place because raising the taxable wage produces a significant increase in revenue, permitting lower tax schedules and experience rates to take effect as the overall trust fund and individual employer accounts increase in solvency. Simply put, raising revenue on a bigger base permits lower tax rates to produce equivalent revenues.

Massachusetts last raised its taxable wage base in 1992. Although the wage base was initially raised from $7000 to $10,800, with another increase to $13,000 called for, the Legislature backed off before this latter increase was effective, leaving the level at $10,800. The state's taxable wage base has remained at this level since 1992 despite considerable growth in wage levels. From a policy perspective, the erosion of the

state's taxable wage base will make a return to forward funding more difficult and undercut trust fund solvency efforts. Raising the taxable wage base is a critical first step toward reforming UI financing in Massachusetts.

2. Index Taxable Wage Base to Statewide Average Weekly Wages

A second key recommendation is that the taxable wage base should be indexed to the growth in statewide wages so that the UI financing structure keeps pace with future growth in wages. Since benefit levels increase with wages, a fixed taxable wage base necessarily creates financing pressures as benefit payments rise while the tax base remains steady. Eighteen states index their taxable wage bases to growth in statewide average weekly wages.

Wayne Vroman, the leading economic researcher on UI financing, has found that states with indexed taxable wage bases have increased capacity to maintain trust fund reserves over time and an improved ability to survive recessions without insolvency.[12]

In 1992, when Massachusetts last raised its taxable wage base, the statewide average weekly wage was $569. By the twelve months ending in June 2003, the average weekly wage in Massachusetts had grown to $862. Even a significant increase in the taxable wage base would leave the state far behind historic taxable wage base levels. For example, in 1970 when the state's taxable wage base was $3600, taxable wages levels still represented more than half of statewide total wages. Currently, the proportion of taxable wages to total wages is less than 30 percent.

Indexing will end the erosion of the UI financing tax base and strengthen trust fund solvency. Indexing the taxable wage base is critical if Massachusetts wants to avoid the low tax/low trust fund trap in future economic downturns.

3. Halt Rate Schedule Intervention by the Legislature

The third recommendation of this report is that the Legislature stop interfering with the operation of the statutory UI tax schedules. The operation of the statutory tax schedules is a key element in forward funding of the Commonwealth's UI trust fund. As claims rise and trust fund balances fall, the statutory tax tables are designed to distribute the cost of benefit payments to individual firms and to employers as a whole. To the degree that the Legislature interferes with this process by halting rate schedule adjustments, a series of small tax increases are transformed into a serious solvency question in future years.

The majority of states forward fund their state UI trust funds. A policy of forward funding of the state's UI trust fund promises significant benefits. Forward funding translates to a solvent trust fund that enables the state to ride through moderate recessions without federal borrowing or significant tax increases. Forward funding means that federal interest payments on trust fund balances pay for higher proportions of UI benefits than happens under a low tax/low trust fund policy. We estimate that since 1994, Massachusetts lost between $300 and $970 million in federal interests due to its low tax/low trust fund policy.

This report has demonstrated that what appeared to be a pain-free state policy of reducing UI taxes and keeping UI trust fund balances low during the 1990s has, in fact, produced severe consequences. Having borrowed and repaid loans in the early 1990s recession, the Massachusetts Legislature started lowering UI tax rates as soon as the UI trust fund again reached minimal solvency in 1994. Between 1994 and 2003, Massachusetts lowered its UI tax rates by over half, providing about $1.7 billion in UI payroll tax reductions and costing the trust fund hundreds of millions in lost federal interest.

Legislation keeping higher tax schedules from taking effect has been passed in nine of the last ten years. Employers, legislators, and other interested parties have viewed each of these bills as having only a minor impact, sort of like having "just one more drink" before driving home from a party. However, in cumulative effect, the Legislature has created an unreasonable expectation that the Massachusetts UI program can have lower taxes on employers and adequate benefits for jobless workers. The sobering truth is employers ultimately must foot the bill for the UI program and a recession is always sure to follow a period of economic recovery. For that reason, offering lower taxes during economic good times by maintaining a lower UI trust fund balance represents a false promise that Massachusetts should avoid in the future.

In order to avoid the low tax/low trust fund trap, the Legislature must resist further efforts to stop scheduled tax increases from taking effect in the future. Forward financing of UI must be the policy, a policy accepted by all interested parties and policy makers. Employers must understand that somewhat lower taxes during economic good times are not sufficient reward to offset higher tax bills during recessions. The advantages of forward funding are clear. While there is perhaps no good time to pay UI taxes in the view of employers, paying them during an economic recovery is preferable to paying them during an economic downturn.[13]

Conclusion

In UI financing there is no way for employers to avoid paying for UI benefits in the long run. In insolvent or less solvent states, employers face higher taxes and borrowing from the federal government during recessions. In states with adequate forward-funded trust fund reserves, federal interest payments and bigger trust fund balances enable UI programs to ride through most recessions. Taxes increase less significantly in recessions, but don't fall as low during economic recoveries.

By better understanding and reacting to the causes for its current solvency crisis, Massachusetts can address its current financing crisis and avoid falling into the low tax/low trust fund trap in the next recession. The three key recommendations of this paper—a higher taxable wage base, indexing of the taxable wage base, and permitting statutory tax schedules to operate as intended—will restore forward funding of the Commonwealth's trust fund. Without these measures, Massachusetts will fall once again into the same UI financing trap.

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Additional Reading on UI Financing and Solvency

Advisory Council on Unemployment Compensation, Defining Federal and State Roles in Unemployment Insurance (U.S. Department of Labor, Washington, D.C., 1996), especially Chapter 5.

Marc Baldwin, *Boom and Bust: Financing Unemployment Insurance in a Changing Economy*, (National Employment Law Project, New York, April 2001).

Massachusetts State Senate, Committee on Post Audit and Oversight, *Broken Trust: Fixing the Unemployment Insurance Trust Fund in Massachusetts*, (Boston, April 2003).

Minnesota Legislature, Office of the Legislative Auditor, *Financing Unemployment Insurance*, (January 28, 2002), available at http://www.auditor.leg.state.mn.us/ped/2002/0204sum.htm.

National Employment Law Project, "Unemployment Insurance Trust Funds: What Is Solvency and Why Is It Important?" (April 2001).

Wayne Vroman, Topics in Unemployment Insurance Financing (Kalamazoo, Michigan. Upjohn Institute, 1998).

Endnotes

[1] This paper relies upon a number of longer treatments of unemployment insurance financing, especially the works by Marc Baldwin and Wayne Vroman listed as Additional Reading just above. NELP recently issued a separate report focusing on the economic advantages of having a strong UI program in Massachusetts. *Protecting Working Families and Our Economy: Unemployment Insurance in Massachusetts* (NELP and Greater Boston Legal Services, October 2003). All NELP publications are available on our website.

[2] Federal UI trust funds are derived from an 0.8 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 Extended Benefits, and a loan fund for insolvent state UI trust funds. In the case of the temporary extensions currently available, federal trust funds are also the source of these benefit payments. These federal funds were also the source of a one-time federal "Reed Act" distribution of $193.6 million deposited in Massachusetts's UI trust fund in March 2002.

[3] Wayne Vroman, Topics in Unemployment Insurance Financing (Kalamazoo, Michigan. Upjohn Institute, 1998), p. 100-104. States avoid interest charges on federal loans if they quickly repay them in certain circumstances.

[4] Most non-profits organizations and governmental units are "reimbursing employers." In other words, they reimburse the state on a quarterly basis for UI benefits paid to their laid off employees, rather than paying experience-rated state UI payroll taxes as in the case with private sector employers.

[5] Senate Committee on Post Audit and Oversight, *Broken Trust: Fixing the Unemployment Insurance Trust Fund in Massachusetts*, (Boston, April 2003), p.8, and Mass. General Laws, Ch. 151A, Sec. 14(j).

[6] *See* Mass. Gen. Laws Ch. 151A, Sec. 14. For a more detailed explanation of how the tax schedules work, see Senate Committee on Post Audit and Oversight, *Broken Trust*, pp. 8-9.

[7] Senate Committee on Post Audit and Oversight, *Broken Trust*, pp. 16.

[8] Wayne Vroman, Topics in Unemployment Insurance Financing, pp. 5-23.

[9] Advisory Council on Unemployment Compensation, *Unemployment Insurance in the United States: Benefits, Financing, Coverage* (Washington, D.C., Department of Labor, February 1995), pp. 8-12.

[10] For additional background on the 2002 Reed Act distribution, see General Accounting Office, Unemployment Insurance: States' Use of the 2002 Reed Act Distribution (Washington, D.C., March 2003).

[11] The federal advisory council warned in 1996: "The capacity of the UI system for economic stabilization is dependent upon the extent to which it is forward-funded. Under pay-as-you-go financing, which prevails today in many state UI systems, few reserves are available to stimulate the economy when needed because trust funds are not being built up during periods of economic health." Advisory Council on Unemployment Compensation, *Defining Federal and State Roles in Unemployment Insurance* (Washington, D.C., 1996), p. 31.

[12] Wayne Vroman, *Topics in Unemployment Insurance Financing*, pp. 95-98.

[13] Wayne Vroman's February 1997 report for the Commonwealth Center for Fiscal Policy warned that "It would seem far superior to pay more taxes during prosperous times (as 1997 seems to be) than to pay them in a recession when business profits are low." *An Analysis of Unemployment Insurance Financing in Massachusetts* (Commonwealth Center for Fiscal Policy, February 17, 1997), p. 21.

Table 4. Estimated Lost Federal Interest on Massachusetts UI Trust Fund Since the Last Recession

Year	Yr. End Trust Fund Balance- Thousands $	Fed. Interest Paid to Trust Fund- Thousands$	Mass. High Cost Multiple	U.S. High Cost Multiple	Lost Federal Interest w/ Avg. Tr. F.- Thousands$	Lost Federal Interest w/ HCM of 1.0- Thousands$
1994	$184,933	$6,149	0.08	0.59	$38,005	$68,689
1995	$527,273	$25,304	0.22	0.63	$47,829	$90,780
1996	$914,631	$49,691	0.35	0.64	$40,769	$91,652
1997	$1,446,164	$79,563	0.51	0.68	$26,396	$76,258
1998	$1,802,999	$110,391	0.58	0.68	$12,222	$69,923
1999	$1,921,621	$122,576	0.57	0.66	$20,539	$94,264
2000	$2,131,041	$132,037	0.55	0.66	$26,339	$107,927
2001	$1,770,487	$132,697	0.45	0.56	$30,966	$159,558
2002	$919,995	$84,695	0.25	0.45	$57,190	$211,421
Totals	N/A	**$743,103**	N/A	N/A	**$300,254**	**$970,472**

National Employment Law Project calculations of data from U.S. Department of Labor, Handbook No. 394 (1994-2001); and UI Data Summary 2002. The lost interest amount were calculated by multiplying the difference between the end of the year trust fund balance and the specified solvency level by the average yield gained by the trust fund (interest earned divided by end of the year trust fund balance) for each year.