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Federal unemployment insurance in the United States

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Unemployment insurance in the United States is one of the fiscal risk-sharing mechanisms designed to mitigate the negative consequences of economic shocks. The system is based on complementary federal and state benefits, which behave very differently during normal and crisis periods. Thus, unemployment insurance is principally a state competence during normal periods, while the federal government assumes an active role in crisis periods, smoothing the negative impact of economic crises on household consumption and mitigating the heterogeneous effects across states.

This is an element that distinguishes the United States from the European Monetary Union, which lacks automatic fiscal stabilising tools for the area as a whole; consequently the costs arising from shocks have to be assumed by each country individually, which makes it difficult for the area to function homogeneously.

FEDERAL UNEMPLOYMENT INSURANCE IN THE UNITED STATES

The authors of this article are Silvia Albrizio, Juan Carlos Berganza and Iván Kataryniuk.[1]

Introduction

A monetary union faces the challenge of operating under a common monetary policy in situations in which its member states must respond to asymmetric (idiosyncratic) shocks or symmetric shocks with heterogeneous effects. Strengthening economic integration among the members of the union may increase the synchronisation of their business cycles, since, for example, the greater volume of trade arising from integration facilitates the transmission of shocks, not only on the demand side but also on the supply side, due to the greater ease of transmission of technology [see Frankel and Rose (1998)]. However, it may also lead to an increase in the frequency of idiosyncratic shocks or shocks with different impacts, since the disappearance of trade barriers is conducive to greater industrial specialisation [Krugman (1993)].

The United States is a monetary union from which lessons may be drawn regarding the presence of heterogeneous effects across states arising from shocks and how to address them. Examples of recent asymmetric shocks include the Hurricane Katrina natural disaster in Louisiana and the fiscal crisis in Detroit. As regards common shocks with different impacts, one could mention the fall in the price of oil in the period 2014-2015 (with adverse effects on producer states, such as Texas and North Dakota, and positive effects on those using oil as an input), the decline in federal defence spending (which has a greater impact on states in which this activity accounts for a larger proportion of GDP) and the sub-prime crisis, which preceded the 2008 financial crisis and had greater effects in those states with a relatively high level of construction activity [the Sun Belt states (see Chart 1)].

In order to curb falls in production and income that affect specific states or regions, monetary unions have risk sharing mechanisms.[2] These mechanisms, which may be private or public, generally work by limiting the degree of pass-through from the fall in production to household spending. On one hand, agents affected by shocks may obtain employment or financial income from unaffected states or regions (income channel), or may smooth their consumption or investment through credit (credit channel). On the other hand, as an example of a public mechanism, fiscal transfers from a central federal budget may also act as shock absorbers. In the case of the United States, it is estimated [Asdrubali et al. (1996)] that this type of transfer, in the form of public investment by the federal government or social protection mechanisms, has enabled the impact of idiosyncratic shocks on the union to be reduced effectively. One of these mechanisms is federal unemployment insurance, which is the object of the analysis of this article.

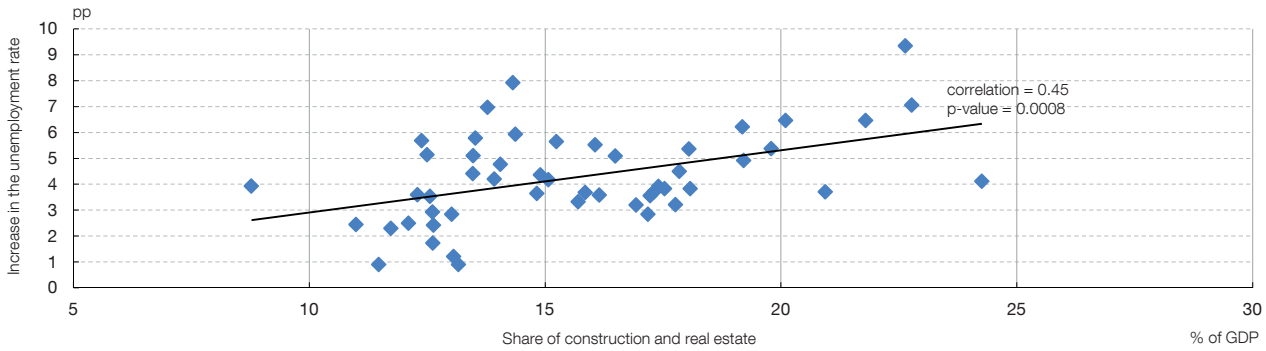
The second section describes the design of unemployment insurance in the United States. In good times the insurance is principally a state competence, while in crisis periods, when significant increases in unemployment occur, the federal government takes on an active role, granting loans to states and making direct transfers to the unemployed. The third section analyses the behaviour of this unemployment system during the recent financial crisis, identifying some of its weaknesses and analysing its stabilising effect on

1 The authors are grateful for the excellent technical support provided by Marina Conesa and Patricia Jiménez.

2 There is evidence that the existence of risk sharing may also foster an increase in the productive specialisation of states [see Kalemli-Ozcan et al. (2003)].

UNEMPLOYMENT INSURANCE IN THE UNITED STATES CHART 1

IMPACT OF THE CRISIS ON UNEMPLOYMENT AND WEIGHT OF THE CONSTRUCTION SECTOR



SOURCES: US Department of Labor, US Bureau of Economic Analysis and own calculations.

activity. The fourth section of this article focuses on the limitations of the current unemployment system and reviews some of the proposals made to reform it. Finally, the last section presents some brief conclusions.

Unemployment insurance in the United States

Federal unemployment insurance, created in 1935 by the Social Security Act, was an important step in the process of regional economic integration in the United States. The system is common to the whole union, but states also have a high degree of discretion to set different levels of taxation and benefits. The system is based on the building up of reserves (generated by social contributions) in good times to finance unemployment benefits in crisis periods. It has two parts, a federal and a state one, which complement one another to give the system consistency. Figure 1 is a schematic representation of the system of contributions and benefits in both the federal and state parts. Federal contributions are paid into a singe federal account, while state contributions are paid into trust fund accounts held by each state.

THE ROLE OF THE STATES

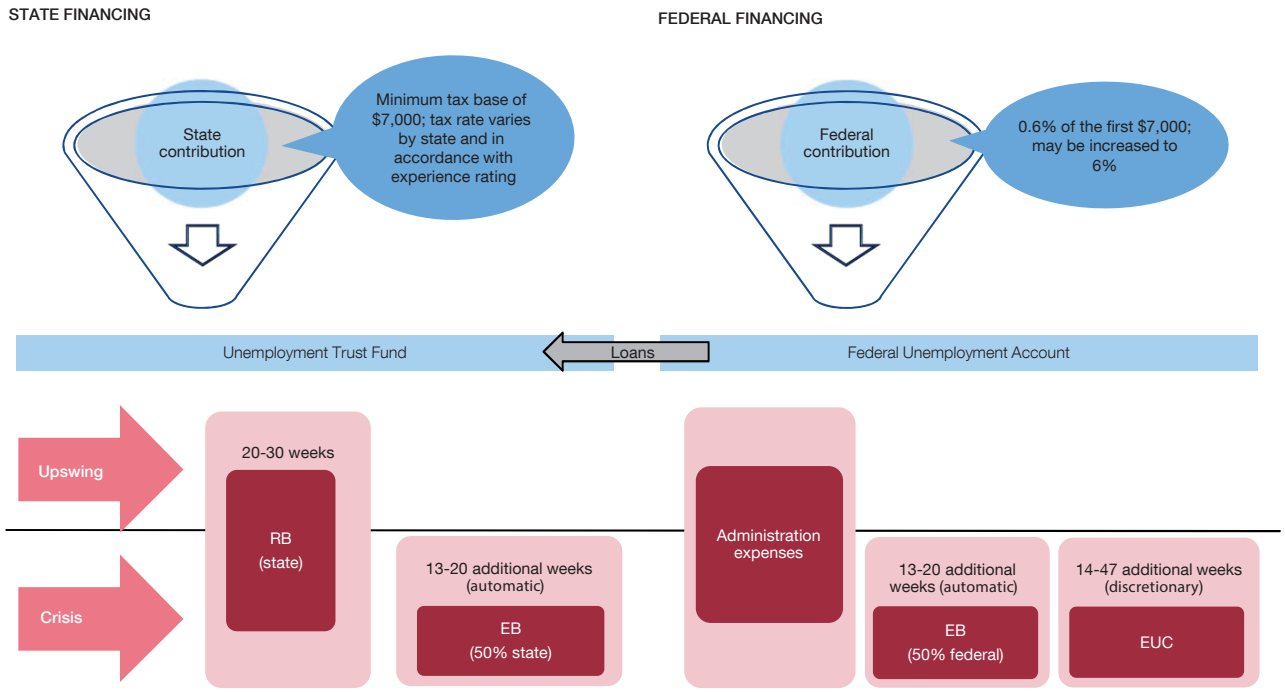
As mentioned above, although there are some common federal rules the main system parameters are set at state level. In the state part of the system the tax base varies from state to state, subject to a lower limit of $7,000. Each state may also decide on the duration of benefits and the replacement ratio (i.e. the ratio between the benefit and previous earnings). The maximum tax base ranges from $7,000 in Arizona, California and Florida, to $45,000 in Washington. As regards the tax rate, each state sets a schedule based on a system of penalising employers (experience rating) according to the layoffs from their businesses in recent years, as well as a number of other factors [Fath and Fuest (2005)]. Thus, the contributions of employers with a low number of layoffs over the preceding three years are determined by applying a rate of close to zero to their tax base, while those with more layoffs are subject to rates ranging from 5% to 11%, depending on the state.

In normal times, persons unemployed through no fault of their own are entitled to state benefits for a period of 20-30 weeks, a significantly shorter duration than in the euro area, as seen in Box 1. As regards the replacement ratio, benefits range from 35% of previous earnings in the case of Alaska to around 60% in Hawaii, a ratio comparable to those in other developed countries (see Box 1). To avoid any hindrance to labour mobility, which is a natural adjustment mechanism in the face of this kind of shock, benefits must be paid – irrespective of where the unemployed worker resides – by the state in which the worker has become entitled to the benefit, which results in transfers between states.

UNEMPLOYMENT INSURANCE IN THE UNITED STATES

FIGURE 1

HOW UNEMPLOYMENT INSURANCE WORKS



SOURCE: Banco de España.
NOTE: RB: Regular Benefits (state benefits). EB: Extended Benefits (automatic federal transfers). EUC: Emergency Unemployment Compensation (discretionary federal transfers).

THE FEDERAL ROLE

Federal expenditure on unemployment is financed by a fixed tax rate that is the same for all states, of 6% on the first $7,000 dollars of the tax base. At the same time, and under normal conditions, employers receive a tax credit of 5.4%, so that the effective rate stands at 0.6%.

The role of federal government differs greatly between boom and bust periods. During booms its role is essentially passive: setting the system's minimum requirements and covering administrative costs. However, in times of crisis it assumes an active role in order to share risks and resolve potential liquidity problems, through two types of action: loans to state accounts and direct transfers.

First, the federal government may mitigate potential liquidity problems through loans from the federal account to exhausted state accounts. If the loan is repaid within the fiscal year, it is considered to be a "cash-flow" loan and is interest free; otherwise interest, which must be paid out of the state budget, is charged at a similar rate to that paid on federal government debt. Moreover, for each year that elapses without repayment of the loan, the tax credit on the minimum federal rate is reduced by 0.3 pp, with the revenue thus raised being used to reduce the level of the debt. Loans help states by providing them with low-cost financing at a time when market funds may become more expensive and by enabling maturities to be extended, which eases a possible credit constraint. However, both the interest on the loans and the automatic increase in contribution rates are mechanisms designed to reduce moral hazard in the fiscal behaviour of states, by discouraging their recourse to the loan system, as against precautionary saving.

Second, the federal government may make direct transfers to unemployed persons, which can be automatic or discretionary. Automatic ones (or extended benefits) correspond to a federal programme extending the duration of benefits during periods of high and rising unemployment at state level, the cost of which is shared equally by the state and federal accounts (see Figure 1). During the last crisis, however, Congress decided that the whole cost of the extension should be assumed by the federal account, since the states had imposed highly restrictive requirements for the activation of the programme, to prevent the increase in benefits from being too onerous for their accounts. Under the current system, automatic transfers are activated in a specific state when the unemployment rate is higher than in any of the preceding three years and also above a particular level (currently 8% for the 20 week extension).[3] These activation requirements are very important to avoid permanent transfers between states.

Discretionary transfers, on the other hand, have been made under eight programmes since 1950 (the latest during the period 2008-2013), which have been approved ad hoc by Congress and financed out of the federal budget. Their activation has also depended on the rate of unemployment at state level.

Results of the system

THE BEHAVIOUR OF UNEMPLOYMENT FUNDS OVER THE CYCLE

As mentioned above, in order to guarantee the budget neutrality of the system, sufficient saving is required during booms to cover the higher outgoings in crisis periods. However, during the years leading up to the 2008-2009 crisis states failed to build up sufficient reserves; indeed, some states cut tax rates during the boom period and reduced the volume of the funds (see Chart 2). For this reason, some authors have argued that, instead of applying the forward funding principle, which ensures that unemployment funds behave countercyclically, states have managed their funds procyclically [see Stone and Chen (2014)]. Moreover, during the crisis there were cases of cuts to unemployment assistance caused by a lack of funds. Specifically, in states such as Georgia, North Carolina and Florida the duration of state benefits was reduced from 26 weeks to between 12 and 23 weeks, depending on the rate of unemployment.

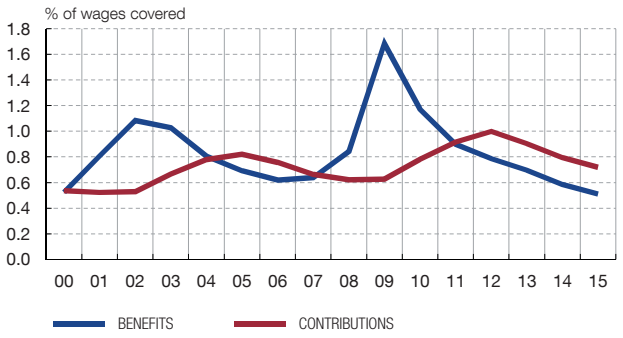
As seen in Chart 2, contributions began to fall before the crisis, leading to a reduction in the rate of accumulation of funds. At the end of 2007, the funds built up by 33 states (held in trust fund accounts) were equivalent to less than one single year of reserves in the event of crisis (a typical measure of the solvency of these programmes). The recession triggered by the sub-prime crisis lasted until mid-2009 (according to the NBER, the institution that dates US recessions), but the labour market took many more quarters to recover, and the inadequacy of state programmes meant that 36 states applied for federal loans. The amount of these loans reached 84% of state benefits and accounted for 0.3% of US GDP.

Currently, with the rate of unemployment close to its natural level, less than half of states have sufficient reserves in their trust fund accounts to pay for a single year of benefits in the event of crisis, and it is likely that when the next recession arrives they will continue to be undercapitalised. That said, the undercapitalisation of these funds is nothing new: according to a report of the Government Accountability Office (2010), the effective rate of tax paid on wages covered by unemployment insurance fell from 1.15% during the decade 1979-1988 to 0.65% in the decade 1999-2008. Current proposals to reform the system

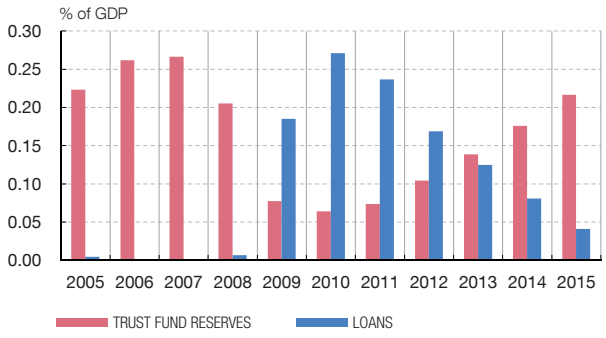
3 In 2012, the Middle-Class Tax Relief and Job Creation Act introduced the Short-Time Compensation Program (optional for each state), which provides a proportionate supplement to the wages of employees who have had their working hours reduced instead of being laid off (work-sharing). The extension of this mechanism would require the parameters for activation of the unemployment insurance system to be adapted in order to provide a uniform and consistent coverage in all states.

UNEMPLOYMENT INSURANCE IN THE UNITED STATES CHART 2

1 UNEMPLOYMENT INSURANCE BENEFITS AND CONTRIBUTIONS (a)



2 FEDERAL UNEMPLOYMENT INSURANCE RESERVES AND LOANS (b)



SOURCES: US Department of Labor, US Bureau of Economic Analysis and own calculations.

a The benefits do not include the Discretionary Transfers Program.
b Reserves bulit up in state trust funds.

would increase the minimum tax base at state and federal level, and link social contributions to the level of reserves of the trust fund account.

STABILISING EFFECT OF THE FEDERAL SYSTEM

As in other unemployment benefit systems, the automatic or discretionary extension of benefits during a period of high unemployment has benefits and costs. The positive aspects include, notably, its role as an automatic stabiliser, since extended benefits enable the purchasing power of the unemployed to be maintained [Chetty (2008)], which, at the aggregate level, provides an additional stimulus for economic recovery. In addition, they enable job searches to give access to jobs that better fit the job seekers' characteristics and facilitate improvement in the employability of the unemployed through training measures, with the consequent efficiency gains. Among the negative aspects, an increase in benefits may slow the return to employment after a recession, by raising the reserve wage and reducing the intensity of job search.

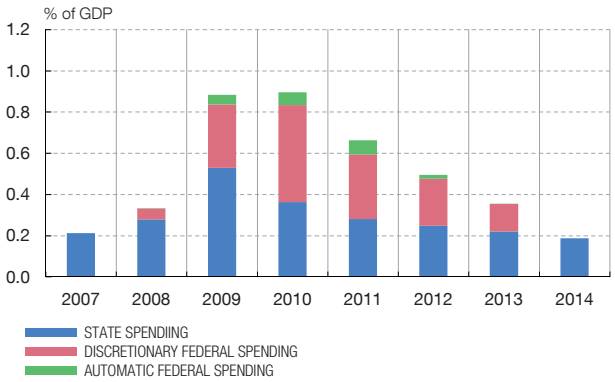
During the financial crisis, spending on unemployment benefits in the United States reached a high of close to 1% of GDP in 2009 and 2010. Around half of this spending corresponded to federal spending, which was mainly discretionary (see Chart 3). In order to analyse how the impact of this spending varies between states, an approximation of its macroeconomic effect has been made. Chart 3 represents the impact of federal transfers on the activity in each state, taking into account federal spending by state (between 2008 and 2013) and using a range of standard multipliers for the unemployment benefits[4] [Congressional Budget Office (2010)]. As can be seen, the federal government spent around 2% of cumulative state GDP on benefits in the states in which the economic crisis had a greater effect in terms of employment, double what it spent in those states in which the effect was lower. This had a cumulative impact on GDP of between 1.5 and 4 percentage points in the first case and between 0.5 and 2 percentage points in the second, from which it may be concluded that federal benefits significantly smoothed the impact of the economic crisis across states.

It should be noted that, although the above estimate provides an indicative value of the economic impact of benefits, it does not approximate the net economic impact of the unemployment system, since the latter should also include the impact of contributions and

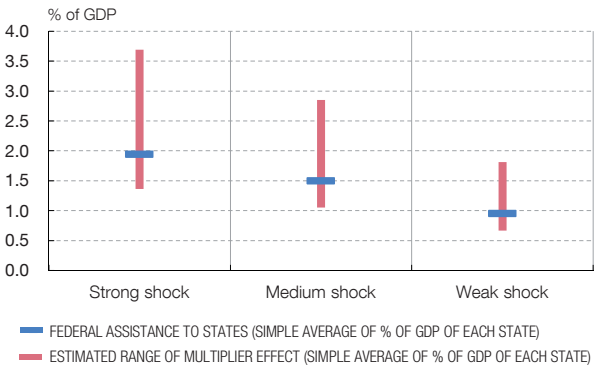
4 These calculations refer exclusively to the federal part of unemployment insurance, since a specific multiplier is used for federal spending [Congressional Budget Office (2010)]. As seen in Chart 3, spending in the state part of the system also increased during the recession, though to a lesser extent than in the federal part.

UNEMPLOYMENT INSURANCE IN THE UNITED STATES CHART 3

1 FEDERAL AND STATE SPENDING ON UNEMPLOYMENT TRANSFERS



2 FEDERAL TRANSFERS AND ESTIMATED EFFECTS ON STATE ACTIVITY (a)



SOURCES: US Department of Labor, US Bureau of Economic Analysis and own calculations.

a The states are classified into three groups according to the size of the increase in the state unemployment rate (in percentage points). The spending and economic effects are calculated in terms of the GDP of each state. The range of multipliers includes a minimum coefficient of 0.7 and a maximum coefficient of 1.9, in line with the analysis of the Congressional Budget Office (2010).

the opportunity cost of loans. In this respect, an increase in labour taxes may affect households' consumption and employment decisions and firms' hiring decisions. In addition, these taxes affect low and moderate income taxpayers to a greater degree, who have a higher marginal propensity to consume [see Parker (1999), Dynan et al. (2001) and Jappelli and Pistaferri (2014)].

For its part, the contribution of federal loans to state finances may be approximated by means of the differential between the interest rate on state debt and the interest rate applied to these loans. This differential will vary according to the economic situation and the policies applied in each state, as well as its credit rating. During a crisis, a rating downgrade may have a significant effect on the interest rate on state bonds, increasing the implicit gain from the federal loan.

Unemployment insurance: problems and reforms

Unemployment insurance in the United States provides important benefits to workers and to the economy as a whole. However, experts[5] have highlighted a number of shortcomings that have given rise to various reform proposals, some of which have already been implemented.

— Federal transfers: the automatic benefit extension programme imposes too many restrictive conditions in the event of severe crises, since the activation criteria come into operation very slowly and are withdrawn before conditions have improved sufficiently. This makes a larger discretionary stimulus necessary. In this respect, the budget proposal by President Obama for 2017 contained some suggestions for improvement, such as an expansion of the federal financing of the programme to 100%, or the coverage of up to 52 weeks in states that either record rapid increases in the rate of unemployment or experience a high rate of unemployment.[6] This would increase risk-sharing,

5 See, for example, *Fiscal Year 2017, Budget of the U.S. Government*.

6 Four thresholds would be set, at 6.5%, 7.5%, 8.5% and 9.5%, and if and when the unemployment rate of the state reaches these levels, 13 additional weeks would be added to the unemployment insurance. This additional period would also apply if the unemployment rate were below these threshholds, but rising rapidly. For example, if the unemployment rate in a state stands at 5.5%, but has increased by 1 pp over the previous year, then it would also be possible to extend unemployment benefits by 13 weeks.

as the extended benefits would be financed by the federal account, which would also require increasing the federal part of contributions.

— Some analysts have proposed an additional activation mechanism, depending on the unemployment rate at federal level [West et al. (2016)]. This mechanism would be financed by re-establishing a tax of 0.2% on the wages paid by employers (which was in force until 2011, when the tax rate at federal level was 0.8%) and by raising and inflation indexing the amount on which federal taxes are payable.

— The aim of these measures is generally to extend and adapt automatic transfers, to make them the main instrument of federal provision of unemployment benefits in the event of crisis, and to reduce the weight of discretionary transfers, which in the last crisis was notably higher than that of automatic ones. It should also be taken into account that the launch of discretionary transfers depends on political agreement at federal level, the difficulty of which will depend on the balance of power in the House of Representatives and the Senate.

— Loans: as was highlighted during the crisis, the system of payment of interest on loans penalises states that are fiscally responsible but subject to a prolonged crisis. For this reason, a solvency rule was introduced in 2014 which enabled states to access a federal system of interest-free loans. This mechanism has a period of deployment until 2019. Access to such loans depends on three conditions: i) having built up, in at least one of the last six years, a level of trust fund reserves covering one year of benefits in the event of crisis; ii) not having reduced social contributions by more than 20 pp since the last time that criterion (i) was fulfilled; and iii) having a level of contributions that covers a reasonable amount of unemployment benefits. Only six states (Alaska, Hawaii, Maine, Montana, Oregon and Washington) complied with this solvency rule in 2007.

— Administration and active labour market policies: the unemployment system in the United States was originally designed as a passive system based largely on unemployment benefits and without significant active policies. Over the years the system has gradually incorporated certain active labour market policies. For example, requiring that job search be a condition for eligibility for unemployment insurance and offering incentives to states through mandates and discretionary subsidies to provide active labour market policies. In this respect, the Middle Class Tax Relief and Job Creation Act of 2012 introduced certain additional mechanisms to assess employability, along with programmes to assist job search. Against this background, it should be noted that generally re-employment mechanisms require policies and service provision to have a decentralised dimension, in order to offer personalised policies and services adapted to the local level. However, the coordination of active labour market policies at federal level may increase the efficiency of these programmes, by creating knowledge and skills spillovers,[7] reducing the skills mismatch and ensuring uniform re-employment support across states.

7 Of the funds available for work sharing, 0.25% are reserved for teaching activities and the sharing of best practices across states.

Conclusions

In a monetary union, greater economic integration may contribute to increasing the pass-through of macroeconomic shocks between the members of the union, synchronising their business cycles. At the same time, it may increase the heterogeneity of the impact of shocks across states, given the greater productive specialisation that may be generated among them. To reduce the differences in the negative consequences of economic shocks, mechanisms may be instituted at union level to share fiscal risks, for example, through unemployment insurance.

In the United States the system of unemployment insurance is based on complimentary federal and state benefits, financed through federal and state contributions paid, respectively, into a single common account and trust fund accounts. One of the main features of the system is the difference in behaviour during normal and crisis periods. First, states build up a buffer of funds in good times to provide unemployment benefits during crisis periods, applying the forward funding principle. Second, while the federal government assumes a passive role in normal times, when it confines itself to setting the minimum requirements of the system and to covering administrative costs, in crisis periods it assumes an active role, to promote risk-sharing and to resolve potential liquidity problems by means of loans to state accounts and direct transfers.

These mechanisms facilitate the automatic stabilisation of the economy, smoothing the impact of economic crises on household consumption and mitigating the differences in the effects across states. Indeed, this is an aspect which distinguishes the United States from the European monetary union, which lacks automatic fiscal stabilisation instruments for the area as a whole to allow sharing of the risks arising from idiosyncratic shocks in individual countries or common shocks that have different effects in each country. In the absence of these mechanisms the costs arising from these shocks must be assumed by each state, which makes it difficult for the area to function homogeneously. In the United States by contrast it is estimated that during the last recession federal unemployment benefits had a cumulative positive impact on GDP of between 1.5 and 4 percentage points in the states most affected. At the same time, the design of the system ensures that federal transfers are confined to crisis periods, thus avoiding a constant flow of funds to particular states.

25.5.2017.

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Unemployment systems generally vary considerably from country to country as to their design and how they are applied in practice. In particular, there are differences as regards their financing (e.g. federal and state taxes), benefits (contributory/non-contributory, duration, conditionality etc.) and active employment policies. Countries also differ as regards the operation of other automatic stabilisers, institutions and social networks, which affect the labour market. Although this heterogeneity prevents a precise comparison of the US unemployment system with those of other countries, and in particular with country aggregates (euro area and OECD), the table below attempts to situate the US unemployment system in the international context.

In terms of the size of the shock and the consequent government spending during the recent crisis, the United States suffered a larger increase in unemployment (from 5% in 2005 to 9.4% in 2009-2010) than on average in the OECD and euro area countries, while it spent 1% of GDP per annum on unemployment benefits (state and federal), in line with the OECD countries, although the rise in its spending was notably larger (United States: 0.7 pp; OECD: 0.2 pp). In terms of the unemployment system parameters, the US replacement ratio is higher than the UK one, but below the Japanese one and also below the median ratio in the euro area and OECD countries. In 2010, the maximum duration of regular benefits in the United States was the same as in the United Kingdom, but was notably lower than in the euro area. If the additional weeks of the federal programmes are included, the maximum duration of benefits in the United States may exceed the duration of benefits in the euro area.

Table
UNEMPLOYMENT INDICATORS (a)

Rate of unemployment (%) (b)	2005	2009-2010	2014
United States	5.1	9.4	6.2
United Kingdom	4.8	7.7	6.1
Euro area	9.0	9.8	11.6
Japan	4.4	5.1	3.6
OECD	6.6	8.2	7.4
Replacement ratio (% NET) (c)	**2005**	**2009-2010**	**2014**
United States	62.0	60.0	61.3
United Kingdom	19.0	19.0	19.8
Euro area	64.2	66.3	66.2
Japan	66.0	67.5	69.3
OECD	60.1	62.9	63.3
Government spending on unemployment benefits (% GDP) (d)	**2005**	**2009-2010**	**2013**
United States	0.3	1.0	0.4
United Kingdom	0.2	0.4	0.3
Euro area (e)	1.2	1.6	1.5
Japan	0.3	0.3	0.2
OECD	0.8	1.0	0.9

Duration of regular unemployment benefits (weeks) (f)	2010
United States	26
United Kingdom	26
Euro area	62
Japan	17

SOURCES: Datastream, OECD and Social Policy Indicators.

a The euro area and OECD country indicators are simple averages.
b Rate of unemployment as a percentage of the labour force (persons aged 15-64). Source: Datastream.
c Net replacement ratio for a single worker, with previous income = 67% of average wage: initial phase of unemployment. Elegible for unemployment insurance, but not qualifying for housing assistance in cash or social assistance. Source: OECD, *Tax-Benefit Models.*
d Government spending on unemployment benefits (% GDP). Sources: OECD.
e Not including Cyprus, Lithuania or Malta.
f Duration of regular unemployment benefits: maximum number of weeks during which the laid-off worker receives the regular unemployment benefit. Source: *Social Policy Indicators.*