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## INTRODUCTION TO UNEMPLOYMENT INSURANCE

by Hannah Shaw and Chad Stone

The federal-state unemployment insurance system helps many people who have lost their jobs by temporarily replacing part of their wages. Created in 1935, it is a form of social insurance, with contributions being paid into the system on behalf of working people so that they have income support if they lose their jobs. The system also helps sustain consumer demand during economic downturns by providing a continuing stream of dollars for families to spend.

The basic unemployment insurance program is run by the states, although the U.S. Department of Labor oversees the system. The basic program typically provides up to 26 weeks of benefits to unemployed workers, replacing about half of their previous wages, on average.<sup>1</sup> States provide most of the funding and pay for the actual benefits provided to workers; the federal government pays only the administrative costs. Although states are subject to a few federal requirements, they are generally able to set their own eligibility criteria and benefit levels.

The permanent Extended Benefits (EB) program provides an additional 13 or 20 weeks of compensation to jobless workers who have exhausted their regular benefits in states where the unemployment situation has worsened dramatically (regardless of whether the national economy is in recession). The total number of weeks available depends on a state's unemployment rate and its unemployment insurance laws. Normally the federal government and the states split the cost of EB, but currently the federal government is fully funding the program under the 2009 American Recovery and Reinvestment Act.

During recessions and while unemployment remains high during recoveries, the federal government has historically created temporary, wholly federally funded programs providing further weeks of benefits. Congress created the most recent such program, Emergency Unemployment Compensation (EUC), in June 2008. Workers who exhaust their regular state UI benefits before they can find a job can receive up to 34 weeks of EUC benefits regardless of their state's unemployment rate; workers in states with high unemployment rates can receive up to 53 weeks of

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<sup>1</sup> In 2007, the most recent year for which data are available, the average worker collecting UI received benefits equal to about 47 percent of lost earnings. This replacement rate is calculated by the Department of Labor from a sample of administrative data that looks at individual unemployed workers' claims. The Department of Labor also publishes a different statistic that calculates the replacement rate as the average weekly benefit amount divided by the average weekly wage of all employed workers. The replacement rate calculated in this way was 35.9 percent in the third quarter of 2009. The difference between the two ways of calculating the replacement rate arises from the fact that the wages of people actually receiving benefits are lower than the average wage of all employed workers.

EUC benefits, as well as EB benefits if their state's unemployment insurance laws allow it. Some states also may offer additional benefits under separate state-funded programs.

The following analysis explains:

- who is eligible for unemployment insurance;
- what kind of benefits it provides;
- what additional benefits are available during economic downturns;
- how unemployment insurance is funded; and
- how unemployment insurance can stimulate the economy.

## **Who Is Eligible for Unemployment Insurance?**

To qualify for unemployment insurance benefits, a person must:

- (1) have lost a job through no fault of his or her own;
- (2) be ready, willing, and able to take a "suitable" new job; and
- (3) have earned at least a certain amount of money during a "base period" prior to becoming unemployed. The standard base period is the first four of the last five completed calendar quarters at the time the person files for benefits, but states can adopt an alternative base period consisting of the four most recent complete calendar quarters.

States vary considerably in how they apply these general criteria. For example, some states do not cover part-time workers unless they are willing to take a full-time job, while other states allow these workers to qualify even if they are seeking another part-time job. Also, many states use the alternative base period for determining eligibility, while others use the standard base period.

For the past 25 years, fewer than half of unemployed workers have actually received unemployment insurance, except during recessions.<sup>2</sup> To be sure, unemployment insurance is not designed to cover all unemployed workers; it does not cover people who leave a job voluntarily, people looking for their first job, and re-entrants who previously left the labor force voluntarily. The program's goal is to provide temporary assistance to workers who lose their jobs through no fault of their own. However, the growing percentage of unemployed workers who meet that criterion yet fail to satisfy the program's increasingly outdated eligibility criteria has made it harder for the program to fulfill its mission.

In 1994, President Clinton and congressional leaders appointed a bipartisan commission to address these problems. The commission identified a number of serious problems with UI eligibility and other rules and recommended a series of reforms. While some states instituted some of the reforms, the federal government made no comprehensive effort to consider the recommendations until very recently. The 2009 Recovery Act made \$7 billion available to states to modernize their unemployment insurance law to expand eligibility; by the beginning of 2010, 28 states had accepted the federal funds and several more were considering it. If states maintain these reforms and more states adopt them, the share of unemployed workers who receive benefits in non-recessionary times should be higher in the future.

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<sup>2</sup> The share was less than 40 percent prior to the start of the current recession, but it is now much higher. The rate goes up in recessions because job losers account for a larger fraction of the unemployed and because people unemployed for 27 weeks or longer may continue to receive benefits through temporary, federally funded programs.

## **What Kind of Benefits Does Unemployment Insurance Provide?**

Workers receive unemployment benefits from the state where they were employed, even if they reside in a different state. When someone applies for benefits — typically over the phone or the Internet — the state determines whether the person is eligible and the amount of benefits for which he or she qualifies. The benefits provided to any particular individual will vary in two respects: the number of weeks that they last and their weekly dollar amount.

*Number of weeks.* While some states simply provide the same number of weeks of benefits to all unemployed workers, most states vary the number of weeks according to the amount of a worker's past earnings, whether the worker had earnings in each of the four calendar quarters that make up the base period, and how evenly those earnings were distributed over the base period.

In most states, workers are eligible for a maximum of 26 weeks (workers in Montana and Massachusetts can receive up to 28 and 30 weeks, respectively), although many UI recipients qualify for fewer than the maximum number of weeks because of uneven earnings or a brief work history. In normal economic times, most workers find new jobs before using the maximum number of weeks available; before the current recession, the average UI recipient received benefits for 15 weeks.<sup>3</sup>

*Dollar amount.* The average unemployment benefit is about \$300 per week (in early 2010). However, individual benefit levels vary greatly depending on the state and the worker's previous earnings. In addition, in several states, workers receive higher benefits if they have dependents.

State laws typically aim to replace about half of a worker's previous earnings up to a maximum benefit level. The maximum state-provided benefit currently ranges from \$235 in Mississippi to \$629 (\$943 with dependents) in Massachusetts. Because the benefit is capped, UI benefits replace a smaller share of previous earnings for higher-wage workers than lower-wage workers. In 2007, the most recent year for which data are available, the average UI recipient nationwide got a benefit that replaced 47 percent of his or her earnings, but that "replacement rate" ranged from 31 percent in Alaska to 57 percent in Hawaii.

The Recovery Act temporarily increased weekly benefit amounts by \$25 a week for all UI recipients. Also, while unemployment compensation is normally subject to federal income taxes, the Recovery Act exempted the first \$2,400 of UI benefits from federal income taxes for 2009; policymakers are likely to extend the exemption through 2010.

## **What Additional Benefits Are Available During Economic Downturns?**

Three types of programs can potentially provide extra weeks of benefits to workers in states where unemployment has increased significantly: (1) the permanent federal-state Extended Benefits (EB) program, which is available to hard-hit states even when the national economy is not performing poorly; (2) temporary federal programs that Congress generally establishes during

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<sup>3</sup> Data from US Department of Labor Employment and Training Administration's Unemployment Insurance Chartbook: <http://www.doleta.gov/unemploy/chartbook.cfm>.

national economic downturns; and (3) additional temporary or permanent programs that states sometimes put in place.<sup>4</sup>

*The permanent Extended Benefits program.* Congress enacted the EB program in 1970, though it cut the program substantially in 1981. EB provides additional weeks of benefits to workers in high-unemployment states who have exhausted their 26 weeks of regular UI benefits. The states

administer EB — the worker does not have to apply to a different office — and the weekly benefits are the same as under the basic state UI program. Normally, the federal government and the states split the cost of EB equally. Under the Recovery Act, however, the federal government is fully funding it on a temporary basis.

A state must provide up to 13 weeks of EB when the insured unemployment rate (IUR), or the number of UI recipients as a percentage of the total number of people working in jobs in which they would potentially be eligible for UI, rises to 5 percent.<sup>5</sup> States can also adopt optional triggers based on their *standard* unemployment rate, or the number of unemployed people as a percentage of the total labor force (both employed and unemployed). Under these optional triggers, states can offer up to 13 or up to 20 weeks of EB, depending on their standard unemployment rate (see Table 1). The optional triggers are more likely to activate EB than the IUR trigger, and many states that did not already have the optional triggers in place adopted them to take advantage of Recovery Act funding.

*Temporary emergency federal benefits.* When unemployment is high during recessions and in the early stages of recoveries, the federal government has historically funded additional weeks of emergency benefits for workers who have exhausted their 26 weeks of regular benefits. In 2008 Congress enacted the

TABLE 1: Additional Weeks of UI Benefits Under EB Provisions of Recovery Act	
Unemployment Threshold*	Additional Weeks
<b>Emergency Benefits (EB)*</b>	
at least 6.5 percent, but less than 8 percent	13
at least 8 percent	20
*Not available in all states	

TABLE 2: Additional Weeks of UI Benefits Under EUC Provisions of Recovery Act			
Tier	Unemployment Threshold	Additional Weeks	Total Weeks
1	none	20	
2	none	14	34
3	at least 6 percent, but less than 8.5 percent	13	47
4	at least 8.5 percent	6	53

<sup>4</sup> For more information on the maximum number of weeks UI benefits are available in each state during the current downturn, please refer to “Failure to Renew Federal Benefits Changes the Map for State Unemployment Insurance Coverage,” Center on Budget and Policy Priorities, April 14, 2010, <http://www.cbpp.org/files/4-14-10ui.pdf>.

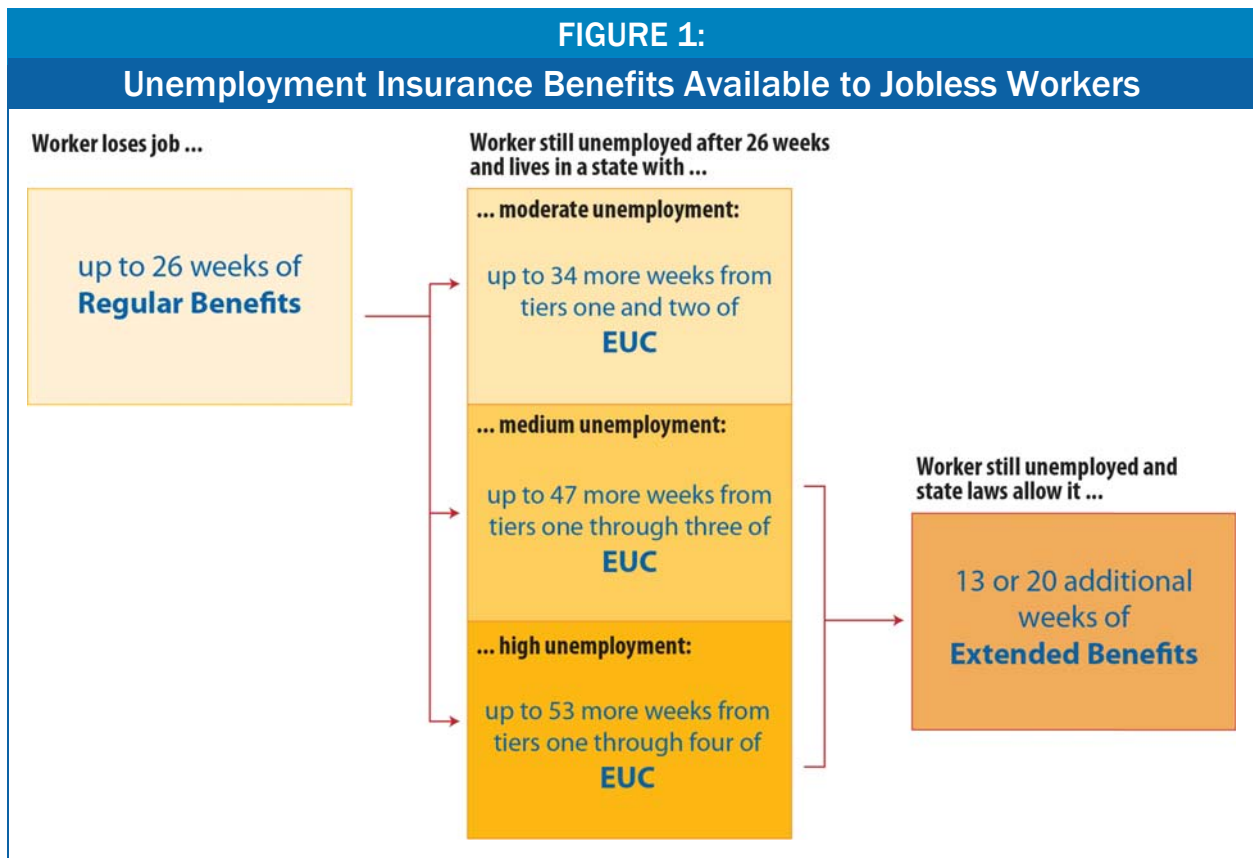
<sup>5</sup> Most workers in the United States — 89 percent of the civilian labor force in 2006 — work in jobs in which they are eligible for UI (i.e., their employers are required to contribute money to the federal unemployment program). However, employees of certain nonprofit organizations, state and local governments, certain agricultural labor and some domestic services, as well as individuals who are self-employed, are not eligible for federal unemployment compensation.

Emergency Unemployment Compensation program (EUC08). Technically, there are four tiers of EUC benefits. The first two are available in all states and together provide up to 34 weeks of additional emergency benefits; the third and fourth are available in states with particularly high unemployment rates (see Table 2).

The Recovery Act established EUC only through the end of 2009, but Congress has extended the program and is likely to continue doing so as long as both the national unemployment rate and the percentage of the unemployed who have been looking for work for 27 weeks or more remain high. At some point the program will begin to phase out, meaning that new exhaustees will not be eligible for EUC benefits but existing EUC recipients will be able to complete whatever tier they are in.

*State programs.* During some downturns, some states have used their own funds to provide additional weeks of benefits to jobless workers who exhaust all other forms of unemployment benefits. Some states also have *permanent* programs that provide additional benefits, but few if any are currently in effect, generally because of flawed triggers or inadequate funds.

The figure below illustrates the flow of benefits available to eligible unemployed workers.<sup>6</sup>



### How Is Unemployment Insurance Funded?

The basic UI system is funded by taxes that employers pay on behalf of their employees. (In a few states, the employee pays part of the tax.) States collect most of these taxes — including the

<sup>6</sup> States are allowed to determine whether to offer EUC or EB benefits first. Alaska is the only state that has opted to pay EB benefits before EUC benefits. A variety of factors enter into the sequencing decision, including expectations about how long full federal funding for EB will be available.

taxes that pay for basic UI benefits — but the federal government collects some of the taxes as well. Temporary emergency federal programs like EUC are funded out of general Treasury funds.

While technically, employers pay both the federal and state taxes, economists generally regard the tax as falling on workers on the theory that the dollars employers pay in tax would otherwise have gone into workers' paychecks.

The federal tax is set by the Federal Unemployment Tax Act (FUTA) and is equal to 0.8 percent of the first \$7,000 paid annually to each employee.<sup>7</sup> This tax is regressive; since most workers earn more than \$7,000 per year, most workers are effectively paying the same flat tax of \$56 per year regardless of income. FUTA taxes thus represent a much smaller share of the wages of high-wage workers than low-wage workers.

The revenues raised by the federal tax (and the general revenue to support temporary programs like EUC) flow into the federal Unemployment Trust Fund. The fund is maintained in four accounts, each of which has a specific purpose: (1) financing the administrative costs to the states of providing unemployment benefits and offering job location and information services; (2) paying the federal share of the Extended Benefits program; (3) making loans to state unemployment programs that run short of funds; and (4) providing benefits to former federal employees. In addition, Congress can draw on the trust fund to pay for additional temporary federal benefits during recessions.

When federal trust fund balances reach a certain high level, additional transfers are automatically made to the states. These "Reed Act" transfers (named after the 1954 legislation establishing this policy) go directly into state unemployment trust funds. States can use this money only for unemployment insurance but are not required to use it to improve or expand their UI benefits.

States too generate funding for unemployment insurance through a tax on employers. The amount of earnings subject to the tax varies, but in most states, it is less than \$10,000. Due to the caps on taxable earnings, the state unemployment insurance tax is, like the federal tax, regressive.

The tax rate applied to these earnings varies not only by state but also by industry; employers in industries with high worker turnover (and therefore a greater likelihood that their employees will apply for unemployment benefits at some point) are generally taxed at a higher rate. In 2008, the average rate applied to *taxable* earnings was 2.5 percent, but because of the cap on earnings subject to the tax, tax collections were just 0.7 percent of *total* earnings. These revenues flow into state unemployment trust funds and are used to pay the actual benefits that workers receive under the regular state program, as well as the state share of benefits under the Extended Benefits program.

The huge increase in the number of UI recipients because of the recent recession has put enormous pressure on the UI financing system. States have had to borrow nearly \$40 billion so far from the federal Unemployment Trust Fund to fund their unemployment programs. Since unemployment is expected to remain high for some time, such borrowing will likely continue for the next few years.

States are required to fully repay the loans, with interest, within two to three years of borrowing the funds. The Recovery Act waived the interest payments through December 31, 2010, but after

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<sup>7</sup> Technically, the gross FUTA tax rate is 6.2 percent, but states with UI programs approved by the Department of Labor and no delinquent loans from the federal trust fund receive a 5.4 percent credit, making the effective tax rate 0.8 percent.

this date, interest will begin to accrue. If a state does not repay the full amount, the federal government will recoup its funds by effectively raising the federal tax on employers within the state.<sup>8</sup>

## **Unemployment Insurance as Economic Stimulus**

Unemployment benefits are designed first and foremost to relieve distress for jobless workers and their families. In recessions and the early stages of recoveries, however, they provide an additional benefit: stimulating economic activity and job creation. In fact, a major reason Congress created the basic UI program during the Great Depression was to help boost the economy and jobs.

In an economic downturn, there is not enough demand for the goods and services that businesses have the capacity to produce. To stop the destruction of jobs and begin to put people back to work, it is critical to stimulate demand. One of the best ways to do this is to target financial relief on unemployed workers who need a replacement for lost income. People whose income is disrupted in a recession and who lack the savings to tide them over are the ones most likely to spend quickly any added income they receive.

Because temporary increases in unemployment insurance benefits are timely and well targeted, they score high in “bang-for-the-buck” calculations of their economic impact as stimulus. The money gets spent fast and its effects spread through the economy. As a result of such policies, local retailers are less apt to lay off workers and cut back on orders from their suppliers during a downturn; and in the early stages of a recovery, they are more apt to hire additional workers and step up their orders.

Because the jobs that greater UI spending preserves or creates are so diffused through the economy, estimating their magnitude has to be done through statistical analysis rather than direct enumeration. Nevertheless, most economists believe they are highly effective. For example, the non-partisan Congressional Budget Office considers temporary additional unemployment benefits one of the most effective ways to boost output and employment, and economist Mark Zandi of Moody’s Economy.com found in 2009 that extra UI benefits were among the best mechanisms under consideration for boosting the economy, with each dollar of benefits providing a \$1.61 jolt to the economy.<sup>9</sup>

## **Conclusion**

More than 70 years after its inception, the unemployment insurance system continues to provide a valuable cushion against income losses from temporary unemployment. It also serves as an effective automatic stabilizer for the overall economy by shoring up workers’ purchasing power during economic downturns. As the economy begins to emerge from the recession, policymakers will face the challenge of putting the system back on a sound financial footing and extending the reforms to fulfill the goal of helping any workers who lose their job through no fault of their own.

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<sup>8</sup> Technically, the FUTA credit is reduced, raising the effective FUTA tax above 0.8 percent.

<sup>9</sup> Douglas W. Elmendorf, “Policies for Increasing Economic Growth and Employment in the Short Term,” Testimony before the Joint Economic Committee, February 2010, pp. 11-12. Mark Zandi, “The Impact of the Recovery Act on Economic Growth,” Testimony before the Joint Economic Committee, October 29, 2009, p. 3.