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The federal-state unemployment insurance system is one of the nation's most important measures against the privation of unemployment. The author here examines the problems of financing the benefits and suggests ways of improving financing, including a proposal for reinsurance to provide against heavy drains on reserves during recessions.

The current federal-state unemployment insurance system has been in operation throughout the country for over a quarter of a century. As one of the two major social insurance programs created by the Social Security Act of 1935,[1] it has become generally accepted as one of the nation's most important measures against the privation of unemployment and as a stabilizer of the economy in helping offset the downdrag on economic activity resulting from excessive joblessness.

Despite its general acceptance, however, it has been subjected to vigorous controversy in recent years. Criticism of the program has focused largely upon two issues, the financing of benefits and the extent of the protection afforded the unemployed by the benefit formula. This paper is concerned with the first of these. The two are closely related, however, since inadequate financing may serve as a deterrent to adequate benefits.

I. Original Financing Provisions

The revenue for unemployment insurance funds is derived almost wholly from payroll taxes levied on employers; only Alabama, Alaska, and New Jersey levy taxes on employees. The Social Security Act set the tax rate on employers at 3 per cent of the first three thousand dollars earned by each employee in a year. Any employer could offset against this tax, however, any amount up to 2.7 per cent of taxable

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1. Social Security Act §§ 1-1105, 49 Stat. 620 (1935), 42 U.S.C. §§ 301-1371 (1959).

payrolls which he contributed to a state unemployment insurance program. Further, if the state had a federally-approved program of experience rating, he might, for example, be assigned a zero rate because of low unemployment costs and still receive the full offset credit of 2.7 per cent against his federal tax liability. The remaining 0.3 per cent of the federal tax was payable directly to the federal government and became the source of grants to the states to pay all the costs of administration.[2]

It was, of course, the obvious intent of Congress to put pressure on the states to establish unemployment insurance systems since they could do so and levy taxes up to 2.7 per cent of taxable payrolls without causing any additional burden on employers. If a state failed to act, then the full 3 per cent was payable to the federal government. All of the states acted and the federal-state system became fully operative by 1937.

Each state became responsible under this system for financing the benefits payable under its formula, determining the eligibility requirements, and the amount and duration of benefits. Hence, each state had to set up its own formula for benefit payments and provide a tax schedule which would finance them, including an adequate reserve fund to maintain the solvency of the program despite the unusually heavy benefit drains which occur during periods of recession.

All states eventually adopted some form of experience rating which provided for a differentiated tax rate structure.[3] This was based on the theory that employers with low unemployment costs—few layoffs —should pay lower tax rates than those with many layoffs and high unemployment costs. It was assumed that by varying the rate in this manner, employers would have an incentive to stabilize employment. The tax schedule in a given state might vary from zero per cent to 2.7 per cent or higher on taxable payrolls. Most of the states had these variable rate structures in effect by the early 1940's. It was the adoption of experience rating systems, therefore, which made possible the decline in tax rates which developed early in the program.

II. NATIONAL TRENDS IN FINANCING BENEFITS

There are three series of data which clearly show trends in the financial experience of the system. These are: (1) benefit cost rates,

2. The Social Security Amendments of 1960 § 523 increased the federal unemployment tax to 3.1 per cent. 74 Stat. 980 (1960), amending INT. REV. CODE OF 1954, § 3301. For tax offset purposes the tax is still 3.0 per cent, hence the effect of this action was to increase the federal tax on employers to 0.4 per cent. INT. REV. CODE OF 1954, § 3302(d)(1).

3. For federal legislation making this possible see INT. REV. CODE OF 1954, §§ 3302(b), (c).

(2) year-end reserve ratios, and (3) average tax rates. They are determined by obtaining the percentage which benefit expenditures, year-end reserves and tax collections each comprised of the same base—taxable wages. Since all three are related to the same base, they are wholly comparable. They are shown by year for the period 1938-1962 for all states combined in Table 1. A careful review of this table reveals considerable information about the significant financial trends which developed over the years in the system and particularly why concern has grown more recently in respect to the financing of benefits.

TABLE 1[4]

Benefits, Reserves and Average Employer Contribution Rates, 1938-1962 All States Combined

Year	*(1) Benefits to taxable wages*	*(2) Reserves as of Dec. 31 to taxable wages*	*(3) Average employer tax rate*
1938	2.18	4.31	2.75
1939	1.59	5.41	2.72
1940	1.72	6.04	2.69
1941	.89	6.53	2.58
1942	.69	6.81	2.19
1943	.13	7.99	2.09
1944	.10	10.01	1.92
1945	.76	11.81	1.71
1946	1.72	10.77	1.43
1947	1.06	10.01	1.41
1948	1.01	9.68	1.24
1949	2.28	9.19	1.31
1950	1.68	8.55	1.50
1951	.93	8.62	1.58
1952	1.05	8.80	1.45
1953	.97	8.95	1.30
1954	2.10	8.51	1.12
1955	1.33	8.14	1.18
1956	1.26	7.81	1.32
1957	1.54	7.68	1.31
1958	3.22	6.37	1.32
1959	1.98	5.98	1.71
1960	2.29	5.57	1.88
1961	2.87	4.86	2.03
1962	2.13	5.00	2.36

4. INTERSTATE CONFERENCE OF EMPLOYMENT SECURITY AGENCIES, REPORT OF COMMITTEE ON BENEFIT FINANCING 6 (Sept. 1959); U.S. DEPT. OF LABOR, UNEMPLOYMENT INSURANCE FINANCIAL DATA, 1938-1962 (rev. ed. 1962).

It will be noted, for example, that the reserves of the system piled up at a very rapid rate during the first eight years of experience, reaching an all-time high when related to taxable wages of 11.81 per cent in 1945. A comparison of column 3 with column 1 shows why. Although the average tax rates began to decline immediately in 1939 as a result of the combination of experience rating with low unemployment costs and continued this decline throughout the eight-year period, they were still much higher than the benefit cost rates and higher than any time after until the 1960's. This difference between tax rates and benefit cost rates is especially noticeable during the war years—1941-45. The average annual benefit cost rate for the whole eight years (1938-1945) was only 0.75 per cent, while the average annual tax rate for the same period was 2.41 per cent. This difference is the source of the rapid accumulation of reserves for the system through 1945. It was the boom period of World War II with its rapidly rising employment and payrolls and very low unemployment levels, coupled with relatively high tax rates which caused the development of this favorable reserve position.

After 1945, however, the picture changed radically. Reserves fell steadily in relation to taxable wages, from the peak of 11.81 per cent at the end of 1945 to an all-time low of 4.86 per cent in 1961. Again a review of average tax rates and benefits cost rates will show how this came about. The average tax rate declined from 1.71 per cent in 1945 to an all-time low of 1.12 per cent for 1954 then rose slowly in succeeding years to reach a figure of 2.36 per cent in 1962—the highest rate since 1941. But the significant feature of this period is that while the tax rate was declining or relatively stable at low levels, the benefit cost rate was rising, in some years very sharply. In fact, for 10 of the 17 years following 1946, the benefit cost rate exceeded the average tax rate. The table above shows also that the greatest increase in benefit costs occurred during the recession years—1949, 1954, 1958, 1960-61. Further, beginning with 1958 when the benefit cost rate soared to 3.22 per cent, it has remained about 2 per cent or higher. To the contrary, the average tax rate did not reach 2.0 per cent until 1961, the first year it had been that high since 1943. The average benefit cost rate for the whole period 1946-1962 was 1.78 per cent, the average tax rate 1.55 per cent. For the five-year period 1958-1962 the average benefit cost rate was 1.51 per cent, the average tax rate 1.15 per cent. Here then is a clear case of underfinancing which became more evident during the last five years of the period. It is also quite obvious that this underfinancing resulted in a process of erosion in reserves which has been in progress throughout the post World War II period, culminating in a drastic fall in the relative reserve strength of the system as a whole. A

particularly important feature of this erosion of reserves has been the severe impact of recession years. The table shows that benefit cost rates exceeded 2 per cent in 1949, 1954, 1958, 1960-61. These years of cyclical downturn caused rapid depletion of reserves and greatly accentuated the effects of underfinancing.

The discussion to this point has been concerned with the financing record of the system as a whole, using data from all states combined, hence, it does not point out how the individual states fared.

III. State Trends in Financing Benefits

It will be recalled, however, that it is the individual states which have the full responsibility for financing benefits within their respective jurisdictions. All states with few exceptions followed national trends and incurred severe shrinkage of reserves after 1945. The extent of this shrinkage by state for selected years is shown in Table 2.

TABLE 2[5]

Ratio of Funds Available to Taxable Wages, by State, at the End of Selected Years

State	*1945*	*1946*	*1949*	*1950*	*1954*	*1958*[a]	*1962*
United States	11.8	10.8	9.2	8.6	8.5	6.3	5.0
Alabama	9.2	8.5	6.8	6.4	7.0	5.1	3.6
Alaska	17.5	18.5	11.8	9.3	3.2	2.8[b]	3.0
Arizona	11.6	11.5	11.3	11.3	11.2	10.1	7.8
Arkansas	10.3	10.7	9.6	8.5	8.7	6.8	4.0
California	15.0	12.9	9.3	8.5	9.1	7.6	4.1
Colorado	11.9	11.6	11.9	11.3	10.9	8.1	4.9
Conneetieut	13.4	13.5	10.9	9.9	11.8	8.8	7.0
Delaware	9.5	8.2	6.7	6.0	5.4	2.2	3.0
District of Columbia	13.2	11.0	9.2	9.0	9.9	9.6	8.5
Florida	10.1	9.8	8.8	8.2	6.3	3.8	4.4
Georgia	11.1	10.8	10.3	9.8	9.7	7.8	6.8
Hawaii	11.8	11.3	11.2	10.7	9.3	8.2	4.0
Idaho	13.0	12.3	12.3	12.2	14.1	10.9	7.4
Illinois	11.3	9.7	8.3	7.4	6.6	4.7	4.8
Indiana	10.5	10.3	8.7	8.3	7.3	5.4	4.2
Iowa	12.2	11.6	11.8	12.0	11.3	9.9	8.4
Kansas	..11.5	12.4	11.1	10.4	9.0	8.3	6.2
Kentucky	15.8	15.2	14.4	13.7	12.2	8.1	7.7
Louisiana	12.6	11.9	10.5	9.8	9.9	9.5	6.4
Maine	12.3	11.7	10.6	9.6	9.6	7.1	4.6
Maryland	12.7	11.3	9.7	8.7	7.1	4.2	4.7
Massachusetts	8.5	7.0	3.4	2.8	7.0	6.5	4.0
Michigan	7.5	6.2	7.2	6.9	7.1	3.8[b]	3.9
Minnesota	10.7	10.4	10.0	9.1	7.8	4.6	1.9
Mississippi	12.0	12.4	13.9	12.2	8.7	5.2	4.5
Missouri	12.0	11.3	10.6	10.4	9.2	7.9	7.1

5. Interstate Conference of Employment Security Agencies, *supra* note 4, at 8-10; U.S. Dept. of Labor, *supra* note 4, at 6.

State	1945	1946	1949	1950	1954	1958[a]	1962
Montana	14.7	14.2	13.4	12.9	15.0	11.7	6.6
Nebraska	10.3	10.3	9.6	9.3	8.3	6.8	5.9
Nevada	16.4	13.5	14.3	12.4	8.9	7.2	5.3
New Hampshire	12.2	10.9	8.3	6.9	5.9	6.0	5.7
New Jersey	16.9	15.6	13.6	12.5	11.7	8.2	6.5
New Mexico	10.2	9.4	10.2	10.2	11.1	9.7	7.7
New York	12.0	10.6	8.3	8.2	10.1	7.8	7.1
North Carolina	13.8	12.5	12.6	11.6	10.4	8.2	7.4
North Dakota	10.9	9.5	9.1	8.6	8.0	5.2	3.4
Ohio	11.4	11.1	10.2	9.2	9.1	5.9	1.7
Oklahoma	9.7	8.7	7.4	6.9	6.2	4.5	3.3
Oregon	11.5	10.9	10.3	8.8	6.5	2.4	4.0
Pennsylvania	11.6	10.3	8.3	7.4	5.0	1.5	1.8
Rhode Island	17.0	16.5	4.9	4.2	3.8	3.9	5.3
South Carolina	11.3	9.9	8.3	7.6	8.3	7.5	6.3
South Dakota	10.9	9.3	8.4	8.6	9.6	8.3	6.6
Tennessee	10.4	11.3	9.8	8.8	7.3	4.6	3.5
Texas	8.5	8.1	8.2	7.9	7.6	5.6	4.6
Utah	14.9	13.9	11.3	10.3	9.7	8.3	6.8
Vermont	12.7	12.0	11.4	10.2	10.1	8.0	4.6
Virginia	9.2	8.6	7.7	7.2	6.5	4.6	5.2
Washington	13.4	12.7	11.5	11.7	11.7	11.1	10.0
West Virginia	10.2	9.3	9.5	8.6	7.3	4.1	4.3
Wisconsin	13.7	13.6	12.4	11.8	11.5	9.6	7.8
Wyoming	10.5	10.1	9.5	9.5	10.4	8.7	3.0

[a] Based on taxable wages for 12 months ended June 30, 1958.
[b] Includes funds borrowed from Federal unemployment account.

It will be noted that by 1962 there were three states which had reserves amounting to less than 2 per cent of their taxable wages. All three, on the other hand, had reserve ratios in excess of 10 per cent of taxable wages in 1945. Eight other states had reserves of less than 4 per cent of taxable wages in 1962. The rate of decline in individual state reserves varied substantially. Those which suffered most severely from the impact of unemployment, especially during recession years, drew down their reserves very sharply. Others with relatively low unemployment rates had much smaller drains on reserves.

More than any other factor, it was the recessions which occurred during the post war period which pointed up the inadequacies of benefit financing in a number of states. As early as the 1949 recession when Rhode Island paid benefits at the then unprecedented rate of 6.2 per cent of taxable payrolls, and in 1954 when Alaska exceeded this record by paying benefits at a rate of 6.5 per cent, concern arose over the adequacy of state financing.[6] In fact, this concern was great

6. As illustrative of this concern, the Commission on Intergovernmental Relations in 1955 recommended "that consideration be given by Congress to authorizing the application of sanctions in time to prevent insolvency of a state fund" and expressed its belief "that the states should be required to maintain an unemployment tax structure likely to assure solvency of state funds." COMMISSION ON INTERGOVERNMENTAL RELATIONS, REPORT TO THE PRESIDENT 209 (1955).

enough to lead to the passage of the Reed Act which provided for loan funds to states caught with depleted reserves.[7] By 1958 the situation had worsened considerably. One state (Alaska) was already insolvent and was able to maintain benefit payments only because of loans from the federal government under the Reed Act. Five more states (Delaware, Michigan, Oregon, Pennsylvania and West Virginia) so depleted their reserves as to become eligible for Reed Act loans between March 1958 and April 1959. Three of these states (Michigan, Oregon and Pennsylvania) actually requested and received loans.

It is pertinent to relate long-range cost and tax rates of the states whose reserves become so depleted as to qualify them for loans.

TABLE 3

Average Cost and Tax Rates, U.S. and Selected States

State	*Ave. Ann. Cost Rate 1949-1958*	*Ave. Ann. Tax Rate 1949-1958*	*Ave. Ann. Cost Rate 1954-1958*	*Ave. Ann. Tax Rate 1954-1958*	*Ave. Ann. Cost Rate 1958-1962*	*Ave. Ann. Tax Rate 1958-1962*
U.S.	1.6	1.3	1.9	1.3	2.48	1.89
Alaska	3.6	2.5	4.4	2.7	3.34	3.21
Delaware	.9	.6	1.2	.6	2.03	1.83
Michigan	2.1	1.6	3.1	1.6	3.53	2.71
Oregon	2.2	1.5	2.5	1.6	2.47	2.61
Pennsylvania	2.1	1.4	2.9	1.7	3.63	2.80
West Virginia	1.9	1.1	2.3	1.1	2.82	2.23

Clearly, all of these states consistently levied taxes at an average rate below their average cost rate. While this is true for the system as a whole, the discrepancy is much more pronounced in these six states.

It is noteworthy also that since 1958, although average tax rates have risen considerably in all six states, only in the case of Oregon did they exceed the average cost rate for the period 1958-62. The Committee on Benefit Financing in 1959 feared that "in the absence of appropriate state or federal action, the next recession . . . is likely to cause critical fund shortages in one-fifth to one-fourth of the states with presently low reserves and with an established practice of levying employer taxes at low average rates relative to their benefit costs."[8] The recession of 1960-61 caused another heavy drain on reserves and several states were in a very precarious position for months; only the upturn in the business cycle saved them from insolvency. There has been some improvement since then, but for the most part, the fear

7. Employment Security Administrative Financing Act of 1954, 68 Stat. 668 (1954).

8. INTERSTATE CONFERENCE OF EMPLOYMENT SECURITY AGENCIES, *supra* note 4, at 14-15.

expressed above concerning critical fund shortages in some states is still appropriate.

Before examining proposals for improving the benefit financing structure of the system, a brief summary will be presented of the underlying factors which brought about its underfinancing.

IV. FACTORS CAUSING UNDERFINANCING

The first and foremost factor in causing underfinancing is the consistent decline in tax rates in the face of increasing potential liability against the funds. This decline was made possible by the differentiated rates permitted by experience rating. Low unemployment costs in the early 1940's combined with this system soon caused sharp declines in the tax rates. Once reduced, it was very difficult to increase them even though prudence and good fiscal management dictated such action. Frequently, the benefit formula was liberalized, thus increasing potential liability at the same time that taxes were reduced. Hence, all interested parties were pleased except those directly concerned with the depletion of the funds. Obviously a sharp upward revision of all tax rates has been needed by many states for nearly a decade in order to offset further reserve shrinkage and steadily increasing potential liability. In some cases it was thought that increasing the maximum tax rate in a given state schedule would provide the needed funds, but the fallacy of this move was soon apparent; the amount of taxable payroll subject to the increased rate was too small to yield appreciable returns. It is true that a number of states had provisions for suspending reduced rates when reserves reached a specified level. However, these safeguards were not reliable. Some were obsolete—using a fixed dollar balance as a safe reserve level,[9] others geared tax rates to fictitious reserves which failed to produce adequate tax schedules, often safeguards were disregarded and bad timing was evident in their operation. Undoubtedly an important consideration influencing low tax rates and making it difficult to increase them has been the state competition for new industry.

A second factor has been the deterioration of experience rating. A majority of states have a formula for variable rates which bases an employer's rate upon his reserve ratio. The basic formula can be expressed as follows:

$$\frac{C\text{-}B}{Tw} = R$$

in which C represents the contributions or taxes the employer has

9. This is, of course, unrealistic in view of the steady inflation of earnings and prices.

paid. *B* the benefits charged to his account, *Tw* his taxable payroll and *R* his reserve ratio. The higher his reserve ratio, the lower his tax will be. The theory supporting this formula is that the employer should pay a tax rate which varies with the unemployment for which he is responsible. As time passed, a practice known as non-charging developed which exempted an employer's account from charges in cases where his former employees quit their jobs or were discharged for misconduct. Other cases of non-charging involved such items as payment of dependents' allowances, benefits to pensioners and claimants taking job training. The sum of these non-charges ran as high as 40 per cent in the case of some states. As a result, employers in such cases had much higher reserve ratios (fictitious reserves) than if such payments had been charged to their account. Hence, it is obvious that the sum of individual employer balances could far exceed the actual reserves available for benefits.[10] The practice of non-charging obviously resulted in a leakage from reserves, there being no corresponding tax offset, and the development of tax schedules which could not support benefit outlays.[11]

A third factor which has seriously crippled the efforts of the states to improve financing has been the fixed tax base. As mentioned previously, the unemployment insurance taxes have been limited to the first three thousand dollars of earnings per worker per year under the Federal Unemployment Tax Act.[12] In 1940, the aggregate taxable wages of the system represented 93 per cent of total wages paid to covered workers, by 1949 the proportion had fallen to 81 per cent, to 72 per cent by 1953 and to 59 per cent by 1962. This ever-widening spread between total earnings and taxable earnings was caused by the inflation of wage rates and earnings. The rapid and sharp increases in wages were reflected in similar increases in benefits, but corresponding increases in tax collections were inhibited by the limit on the tax base. This weakness in financing benefits could have been overcome by sharp increases in tax rate schedules, but as we have seen, this did not occur. An increase in the taxable

10. For example, Tennessee employers as of the end of the year 1962 had net fictitious reserves aggregating $126.5 million, whereas, the trust fund balance was $66.4 million.

11. Another type of leakage relates to benefits ineffectively charged. Benefits charged to employers' accounts with negative balances and who were already paying the maximum tax rate were ineffective since they could not cause any increase in the tax rate.

12. This is still true. INT. REV. CODE OF 1954, § 3306(b)(1). Note however, that Congress has raised the tax base under OASDI from its original $3,000 to $4,800, INT. REV. CODE OF 1954, § 3121, and bills are now in Congress to increase it to $5,200. *E.g.*, H.R. 3087, 88th Cong., 1st Sess. (1963).

wage base has long been regarded as one of the best methods to provide sounder financing of the program.[13]

A fourth factor depleting reserves has been the constant and extraordinary increase in potential liability against the funds of the system arising from such developments as the expansion of the insured labor force, the great inflation of wages and earnings, the liberalization of benefit formulas and higher levels of unemployment in recent years.

Another factor of considerable significance relates to the benefit formula. With the rapid rise in wages and prices, eligibility requirements for benefits in many states became obsolete, allowing claimants to qualify with very limited periods of work in a year. Changes in the composition of the labor force in the last two decades accentuated this weakness in the formula. These changes were the great increases in the number and proportion of part-time, part-year and casual workers with loose attachment to the labor force. Because of low eligibility requirements they have been able to qualify for unemployment insurance benefits for a duration period often in excess of the number of weeks they had been previously employed.

Along with this, there has been a tendency to stretch the benefit formula to cover long-term unemployment by providing for temporary extension of benefits during recessions.[14] This has often resulted in payments to persons not in the labor market who have already exhausted a full round of benefits.

These two developments call for a re-examination of the benefit formulas in some states to assure that a larger share of benefits are paid to workers who do have a substantial labor market attachment. Temporary extensions of benefits by the states beyond the regular duration period set in the law may well impinge upon the insurance principle involved in this program. It is time to recognize the fact that unemployment insurance is not a cure-all for all types of unemployment, especially chronic long-term unemployment. Many new kinds of programs will be needed to cope with the particularized kinds of unemployment which have developed with the progress of automation and other recent changes in our economy.

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13. Fourteen states have acted to increase their own tax base to a higher figure. The federal credit applies only to the first $3,000 of wages earned in a year, hence, any state tax on wages in excess of this limit is not eligible for federal offset. For a detailed discussion of this problem see, INTERSTATE CONFERENCE OF EMPLOYMENT SECURITY AGENCIES, *supra* note 4, at 30-34; LESTER, THE ECONOMICS OF UNEMPLOYMENT COMPENSATION 73-78 (1962).

14. Seven states have provided for state extension of benefits, that is, financed wholly by the state in each case. These programs allow for 50 per cent increases in benefits and are triggered into effect by a downswing in the economy within the state. See, U.S. DEPT. OF LABOR, B.E.S. UI SERVICE, *Comparison* 7 n.5.

V. Proposals To Improve the Financing of Benefits

The federal-state system of unemployment insurance has served the country well as a major source of aid to the unemployed and as a stabilizer of the economy. The weaknesses in benefit financing which have been pointed out suggest, however, the immediate need of improvements in the financing structure of the program. Some critics have proposed that because of these weaknesses, the system should be federalized with a single unemployment insurance reserve fund, instead of the 50 state reserve funds, and with uniform tax and benefit structures applicable throughout the country. This is undoubtedly politically impossible, but it is significant that Presidents Eisenhower, Kennedy and Johnson all suggested "permanent improvements" be made in this system, mostly by way of liberalizing benefits.[15] This cannot be done in some states without extensive improvements in financing such benefits. There is, of course, a strong federal interest in this program and the development of insolvency in several or more states would greatly increase the pressure for federalization.

So far, federal action to improve this situation is limited. There are no federal standards for financing benefits nor are there any standards in respect to benefit amounts and duration. The only federal action in this respect has been the provision for loans to states whose reserves had declined to critical levels. It is worthy of note that the loans which were made in 1958 exhausted the funds available for this purpose.[16]

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15. The McCarthy-King Bill, H.R. 6339, S. 1542, 88th Cong., 1st Sess. (1963), now before Congress provides for a number of changes in the unemployment insurance system, including an increase in the federal tax base from $3,000 to $5,200, equalization grants to states with high benefit costs, higher weekly benefit amounts, federally extended benefits to the long-term unemployed and an additional federal tax on employers of 0.3 per cent of taxable payrolls.

16. The Social Security Amendments of 1960, § 523, 74 Stat. 980 (1960), amending Int. Rev. Code of 1954, § 3301, increased the Federal Unemployment Tax from 3.0 per cent to 3.1 per cent. This higher rate became effective January 1, 1961. For tax offset purposes the rate of the tax is still 3.0 per cent making the federal portion of the tax on employers 0.4 per cent on taxable wages instead of 0.3 per cent. Int. Rev. Code of 1954, § 3302(d)(1). The purpose of this increase was to finance increasing administrative expenses and to provide revenue in excess of those expenses for the purpose of building up a larger fund for making loans to states with depleted reserves. In addition to the 0.4 per cent tax special taxes were levied for the years 1962 and 1963 of 0.4 per cent for the first year and 0.25 per cent for the second year to cover the costs of the federally extended benefits in all states under the Temporary Extended Unemployment Compensation Act of 1961, § 14, 75 Stat. 16 (1961), amending Int. Rev. Code of 1954, § 3301. Also the seventeen states that borrowed funds from the federal government under The Temporary Unemployment Compensation Act § 104, Int. Rev. Code of 1954, § 3302(c), to pay extended benefits will have to pay back these loans at a rate of 0.3 per cent of taxable payrolls. Employers in states not subject to these special taxes are paying the regular federal government tax of 0.4 per cent.

Improvements in this program do not require outright federalization. Steps can be taken to provide for sounder financing and more adequate benefit formulas without resort to this extreme measure. First of all, as mentioned previously, it is time to reaffirm the principle under which the unemployment insurance program can serve the country most effectively. This principle is—that it is an insurance system to protect workers who are regularly and substantially attached to the labor market from wage loss for limited periods of time resulting from involuntary unemployment. Implicit in this principle is the recognition that unemployment insurance cannot protect the unemployed against long-term joblessness, nor afford protection against the unemployment of youth or other new entrants to the labor market. Further, it can provide only limited protection to distressed areas and to the unemployed during periods of recession. This leads to the conclusion that a number of other programs are needed to cope with these problems of unemployment. In this connection it is encouraging to note that Congress has enacted such legislation as the Area Redevelopment Act, the Manpower Development and Training Act and the Vocational Educational Act of 1963. It has also provided for two extensions of benefits, one on a loan basis to the states (1958) and one on an outright grant basis (1961).[17]

The one step which the federal government could make immediately to improve the financing of benefits would be to amend the Federal Unemployment Tax Act to provide for an increase in the tax base from three thousand dollars to some higher figure—say, forty-two hundred.[18] Since 26 states have automatic provisions in their laws which will raise the state tax base to any new level enacted by Congress, they would immediately gain a much sounder financing position by this increase. States without the automatic provision would fall in line quickly. Since there is reason to believe that some states have waited on the federal government to take this action and others probably find it impossible to make this much-needed improvement without federal help, this would seem to be a most important action to strengthen the present program.[19]

17. A federally financed extension of benefits to the long-term unemployed is proposed in the McCarthy-King Bill, *supra* note 15. This proposal is an improvement over the two previous federal extensions of benefits in that payments are confined to workers with substantial attachment to the labor market. Payment under this proposal would be financed by the federal government by an additional tax of 0.3 per cent levied on employers. See note 15 *supra*.

18. The McCarthy-King Bill would raise this to $5,200. *Ibid.*

19. The Committee on Benefit Financing of the Interstate Conference of Employment Security Agencies recommended in 1960 that the wage base be increased through federal legislation to $3,600 and that the tax rate be increased to 4.0 per cent with a 90 per cent offset (3.6 per cent standard rate plus 0.4 per cent for administrative financing and loans). INTERSTATE CONFERENCE ON EMPLOYMENT SECURITY AGENCIES, REPORT OF THE COMMITTEE ON BENEFIT FINANCING 19 (April 1960).

So far as state action is concerned, mention has already been made of the fact that many of the states have taken definite steps to improve their financing position. But progress is too slow to avert disaster if another recession should occur in the next two or three years. Steps which the states might well consider taking as soon as possible include: (1) an extensive rejuvenation of their tax schedules, (2) the elimination of non-charges or a provision for offsetting them by prorating them among all covered employers by means of supplemental tax provisions, (3) an increase in the state tax base regardless of federal action (which may not occur) and, (4) tightening-up of the benefit formula to provide more meaningful eligibility requirements in the light of the inflation in wages.

Even with determined efforts such as these on the part of the individual states towards strengthening their financial position, there still remain two aspects of this problem which can only be adequately treated by cooperative action among the states. The first of these relates to the wide differential which exists among the states in benefit cost rates. States with a high proportion of heavy industry or seasonal and casual industries have, as a rule, much higher benefit costs than those which do not have a concentration of such industries. Hence, they must levy much higher tax rates to cover this risk. But this may be difficult to do because of interstate competition.

Proposals have been made, therefore, including one by the Kennedy Administration to equalize these interstate differentials in benefit cost rates based upon an assumption of interstate responsibility for a part of the burden of the high cost states. Under a cost equalization formula, a state would become eligible for payments from the federal government with respect to any year in which costs exceeded a certain designated level which would be uniform for all states, even though its current costs were below its experienced level.[20] Under the proposed equalization formula embodied in the McCarthy-King Bill,[21] no state could qualify for equalization grants unless it provided benefits equal to the level of benefit adequacy set forth in this bill. There will undoubtedly be much political pressure against the adoption of such a plan since some states—those with low benefit cost rates—will object to paying part of the costs of benefits in high cost states. Further, there will be vigorous objection to the provision for minimum benefit standards included in the bill.

20. Under the McCarthy-King Bill, *supra* note 15, provision is made for equalization grants whereby the federal government would underwrite two-thirds of a state's benefit cost of a year in excess of 2.7 per cent of state taxable wages for that year. If the national benefit cost rate exceeded 2.7 per cent of taxable wages in a given year, the federal government would contribute only towards that portion of a state's cost in excess of the national rate. The cost of this plan would be defrayed out of an additional 0.3 per cent tax on taxable wages.

21. *Ibid.*

VI. A PROPOSAL FOR REINSURANCE

The second aspect of the problem of financing benefits which suggests state and federal cooperative effort has reference to the extraordinary heavy drains on reserves caused by recessions. Sudden, substantial, and unpredictable losses have occurred in many states as a result of the recessions of 1949, 1954, 1958 and 1960-61; in some states decimating reserves. For many years the states have been able to fall back upon reserves accumulated during World War II, but now that reserves are virtually depleted in some states, the need for protection of funds by some cooperative plan among the states is paramount. The point is that with all the recent efforts by the states to improve their financing position, it is quite likely that many of them will be unable to build up their individual reserves sufficiently to cope with a catastrophic benefit cost year. It takes years to accumulate a sound reserve level; however, it can in turn be seriously depleted by recession drains in a single year.

A reinsurance plan would provide a way out of this difficulty. Reinsurance is quite different from cost equalization. Under a reinsurance formula, a state would be eligible for reinsurance payments only to the extent that its costs, however high, were in excess of its own experienced costs. The distinguishing features of an unemployment reinsurance program are (1) a base period which represents a recent and normal benefit cost experience, and (2) a measure of the severity of cost experience in the current period. In a cost equalization plan, on the other hand, specified rates of benefit costs are designated uniformly for all states beyond which costs are shared in the current period, regardless of past experience.

The principle of reinsurance has long been used in private insurance. All forms of insurance are based upon the law of averages, that is, that a large number of uncertainties will produce relative certainty. The theory is that although the loss of a single risk cannot be foreseen, the total losses on all risks may be predicted with sufficient accuracy to make insurance possible. This implies that all risks are of the same amount. Actually, they are not. Unusually large risks may cause catastrophic losses out of proportion to their number. Private insurance companies customarily set up line limits, that is, limitations on the retention of risk, and reinsure the excess of risk over and above such limits. This is often called excess-of-loss insurance. By this means, private insurance companies assure themselves of a safe distribution of risk and stability in loss experience.

This principle is applicable to the federal-state unemployment insurance system. Unemployment is not a homogeneous risk. It varies greatly in length, extent, from area to area, and in its timing.

Its very heterogeneity and the possibility that large, unpredictable losses may occur suddenly, deterred insurance companies from writing this kind of insurance long before the present governmental system was established.

The type of unemployment which causes the greatest threat to the solvency of unemployment insurance funds is mass unemployment resulting from a downswing in the economy. Then too, the national economy and many state economies are undergoing rapid and continuous change. For example, a sudden cancellation of large defense contracts, the removal or decline of certain industries, or other economic events may plunge the state into an unprecedented benefit cost pattern. This is most likely to happen during a strong recessionary movement and intensify it. It is also true that some states, because of their industrial composition respond to nationwide recessions more severely than other states. A mild recession nationally may be sharply felt in a few states. Also, recessions differ in their causes and patterns of development. For example, in 1949 a soft-goods recession developed, whereas in 1958 and 1961, industries manufacturing hard goods suffered more severely. This implies that states most adversely affected will not necessarily be the same from recession to recession and catastrophic declines in reserves may occur in any of them.

A sound reinsurance formula would then give the states the protection they need against sudden, large and unforeseen drains on funds without accumulating excessively large reserves. This is a highly important point since the states with lowest reserve levels may not have the time before the next recession to accumulate such funds in any event.[22]

A new approach to the problem of developing a reinsurance formula which would meet the needs of the states is outlined in the analysis which follows. This formula is based upon the insured unemployment rate and has the following features:

1. Trigger points of 6 per cent, 6 1/2 per cent and 7 per cent annual insured unemployment rates for determining eligibility.
2. Excess loss defined as the excess of benefit costs in the current year over benefit costs in the previous year.
3. The proportion of excess loss reimbursable to be 25 per cent if the trigger point is designated as an annual insured unemployment rate of 6 per cent and over, 37 1/2 per cent if the trigger point is set at an unemployment rate of 6 1/2 per cent and over, and 50 per cent if the trigger rate is 7 per cent and over.

22. Borrowing from the loan fund under the Reed Act, 68 Stat. 668 (1954), 42 U.S.C. §§ 1321-23 (1958), would help the states, but these loans have to be repayed. Also since there is no limit on the cumulation of loans and no solvency standards, there is a tendency in this arrangement to limit state responsibility to whatever tax effort a state chooses to consider acceptable.

If all three trigger points are used simultaneously on a sliding scale basis, then a reimbursable grant of 25 per cent of the excess loss would be made to a state with an annual insured unemployment rate of 6 per cent but less than 6 1/2 per cent, 37 1/2 per cent to a state with an unemployment rate of 6 1/2 but less than 7 per cent and 50 per cent to a state with an unemployment rate of 7 per cent and over.

These three factors may be summarized as follows: The annual rate of insured unemployment for any state is derived by the expression $\frac{u}{52E}$ in which u is the total number of continued weeks of unemployment claimed during the year and E is the monthly average covered employment. If the value of this expression is equal to or greater than the trigger point, a state would be eligible for a reimbursable grant *provided it had excess costs during the year.* If a state met these two requirements it would be reimbursed as indicated above. The provisions for reimbursement may be summarized as follows:

(a) With a trigger point of 6 per cent and over,
$$RG = .25(B\text{-}B_0)$$

(b) With a trigger point of 6 1/2 per cent and over,
$$RG = .375(B\text{-}B_0)$$

(c) With a trigger point of 7 per cent and over,
$$RG = .50(B\text{-}B_0)$$

(d) *Using all three trigger points simultaneously on a sliding scale basis,* the proportion of excess loss reimbursable to a state would be either 25, 37 1/2 or 50 per cent depending on its unemployment rate as explained previously.

In the expressions above RG equals the amount of reimbursable grant, B equals the dollar amount of benefit expenditures during the current year and B_0 equals the dollar amount of benefit expenditures during previous year.

Each of these features will be discussed with examples of how the formula would have worked had it been in effect in recent years and a number of subsidiary points will be considered.

A good case can be made for using the rate of insured unemployment as the criterion for eligibility.[23] Excess costs are directly correlated with high rates of unemployment. Hence it is logical to set some rate or rates of insured unemployment as the trigger points. The question is, what rate or rates should be used? Professor Lester

23. This approach was suggested by Professor Lester although his proposal varies considerably from that recommended here. See LESTER, THE ECONOMICS OF UNEMPLOYMENT COMPENSATION 128 (1962).

proposed a single rate which has appeal in its simplicity. However, the difference between qualifying and not qualifying can be so great in dollar terms that it is hard to justify a single trigger point for determining eligibility. An element of flexibility is called for which would provide a range over which a state could become eligible for differing degrees of cost reimbursement. This is provided in the sliding scale arrangement described above which would give the states the greatest protection. The principle followed in the formulation of the proposed reinsurance plan is that of increasing protection as financing difficulty increases.

As to the method of determining the amount of excess costs, it should be emphasized that we are concerned with temporary increases in costs, which most frequently occur during cyclical declines. These costs arise suddenly, and the bulk of them occur during the early stages of a recession. The difference between the benefit outlay for a recession year and that for the year immediately preceding it is a good measure of the impact of the recession on benefit outlay.

Finally, there is the question as to what proportion of a state's excess costs should be reimbursed. It could be a flat percentage for all states, whatever their qualifying unemployment rate. The analysis here, however, has followed the principle that the higher the trigger point the larger should be the proportion of excess costs for which a state should be reimbursed. It is not proposed, however, that reinsurance should ever bear more than half the burden of excess loss. In other words, a state would be expected to finance a substantial part of its excess costs out of its own funds. This, of course, implies an element of coinsurance. This has the effect of at once conserving reinsurance funds and preventing abuse of the system through benefit formula liberalizations.

VII. Testing and Evaluating the Proposed Formula

The proposed formula and certain possible modifications of it were tested against past state experience. The results indicated that the proposed formula is most effective in pinpointing excess costs in the early stages of a recession and in providing timely and significant aid to the states.

Computations were made using each of the three suggested trigger rates of insured unemployment (6, 6.5 and 7 per cent), and the three associated rates of reimbursement. Computations were also made using all three rates simultaneously on a sliding scale basis. The results for the period 1947 through 1961 are shown in Tables 4 and 5 and are reviewed briefly below:

TABLE 4

Summary of Excess Loss and Amount of Reimbursable Grants by State, for the Period 1947-1961 (Thousands of Dollars)

	Excess Loss Under				*Amount of Reimbursable Grants Under*			
State	*6%*	*6.5%*	*7%*	*Sliding Scale*	*6%*	*6.5%*	*7%*	*Sliding Scale*
Alabama	41,260	38,042	18,282	41,260	10,317	14,266	9,141	17,356
Alaska	11,448	11,448	9,062	11,448	2,864	4,293	4,532	5,427
Arizona	0	0	0	0	0	0	0	0
Arkansas	16,837	10,112	10,112	16,837	4,240	3,792	5,057	6,769
California	389,815	106,556	106,556	389,815	97,454	39,959	53,278	124,093
Colorado	0	0	0	0	0	0	0	0
Connecticut	94,415	94,415	94,415	94,415	23,604	35,406	47,208	47,208
Delaware	0	0	0	0	0	0	0	0
District of Columbia	0	0	0	0	0	0	0	0
Florida	0	0	0	0	0	0	0	0
Georgia	0	0	0	0	0	0	0	0
Hawaii	0	0	0	0	0	0	0	0
Idaho	1,192	0	0	1,192	298	0	0	298
Illinois	0	0	0	0	0	0	0	0
Indiana	43,771	0	0	43,771	10,943	0	0	10,943
Iowa	0	0	0	0	0	0	0	0
Kansas	0	0	0	0	0	0	0	0
Kentucky	66,111	66,111	51,142	66,111	16,528	24,791	25,572	31,185
Louisiana	7,362	0	0	7,362	1,841	0	0	1,841
Maine	21,643	21,643	21,643	21,643	5,410	8,115	10,824	10,824
Maryland	0	0	0	0	0	0	0	0
Massachusetts	113,998	65,196	65,196	113,998	28,500	24,449	32,598	44,799
Michigan	363,152	363,152	254,795	363,152	90,788	136,183	127,398	168,032
Minnesota	0	0	0	0	0	0	0	0
Mississippi	17,782	10,190	10,190	17,782	4,446	3,821	5,096	6,994
Missouri	0	0	0	0	0	0	0	0
Montana	5,858	5,858	5,858	5,858	1,465	2,197	2,930	2,930

TABLE 4 (continued)

State	Excess Loss Under 6%	6.5%	7%	Sliding Scale	Amount of Reimbursable Grants Under 6%	6.5%	7%	Sliding Scale
Nebraska	0	0	0	0	0	0	0	0
Nevada	4,654	3,624	0	4,654	1,164	1,359	0	1,617
New Hampshire	13,817	13,817	13,817	13,817	3,455	5,182	6,909	6,909
New Jerscy	121,027	102,706	63,009	121,027	30,256	38,514	31,505	50,971
New Mexico	0	0	0	0	0	0	0	0
New York	426,585	426,585	172,504	426,585	106,646	159,969	86,252	181,532
North Carolina	31,887	0	0	31,887	7,972	0	0	7,972
North Dakota	164	0	0	164	41	0	0	41
Ohio	248,194	189,551	0	248,194	62,049	71,082	0	85,743
Oklahoma	0	0	0	0	0	0	0	0
Oregon	49,460	49,460	25,762	49,460	12,366	18,547	12,882	21,768
Pennsylvania	426,107	426,107	424,110	426,107	106,527	159,790	212,056	212,805
Rhode Island	46,887	39,140	39,140	46,887	11,722	14,678	19,571	21,508
South Carolina	0	0	0	0	0	0	0	0
South Dakota	0	0	0	0	0	0	0	0
Tennessee	60,797	54,419	45,954	60,797	15,200	20,408	22,978	27,747
Texas	0	0	0	0	0	0	0	0
Utah	0	0	0	0	0	0	0	0
Vermont	6,959	4,606	2,580	6,959	1,740	1,728	1,290	2,638
Virginia	0	0	0	0	0	0	0	0
Washington	62,582	62,582	40,180	62,582	15,646	23,468	20,091	28,492
West Virginia	61,979	49,857	49,857	61,979	15,496	18,697	24,929	27,960
Wisconsin	0	0	0	0	0	0	0	0
Wyoming	0	0	0	0	0	0	0	0
Totals	2,755,743	2,215,177	1,524,164	2,755,743	688,978	830,694	762,097	1,156,402

TABLE 5

Summary by Year—Amount of Reimbursable Grants and Number of States Eligible for Period 1947-1961

Year	*Amount of Reimbursable Grants Under*				*Number of States Eligible Under*			
	6%	*6.5%*	*7%*	*Sliding Scale*	*6%*	*6.5%*	*7%*	*Sliding Scale*
	(Thousands)							
1947	$ 0	$ 0	$ 0	$ 0	0	0	0	0
1948	5,259	0	0	5,259	2	0	0	2
1949	133,041	191,967	225,151	253,319	18	14	11	18
1950	472	707	368	799	2	2	1	2
1951	298	447	596	596	1	1	1	1
1952	597	895	0	895	1	1	0	1
1953	368	551	735	735	1	1	1	1
1954	99,191	142,560	127,153	178,501	15	14	11	15
1955	0	0	0	0	0	0	0	0
1956	0	0	0	0	0	0	0	0
1957	9,040	9,732	7,115	14,064	6	4	3	6
1958	342,968	406,999	318,025	558,138	25	21	17	25
1959	0	0	0	0	0	0	0	0
1960	5,976	7,647	343	8,612	6	5	2	6
1961	91,768	69,189	82,611	135,484	21	13	10	21
Total Excess Loss	2,755,743	2,215,177	1,524,164	2,755,743				
Total Reimbursement	688,978	830,694	762,097	1,156,402				

(a) Using a trigger point of 6% and grant of 25% of excess costs:

No states qualified for grants for the years 1947, 1955, 1956, or 1959. Eighteen states qualified for grants in 1949, 15 in 1954, 6 in 1957, 25 in 1958, 6 in 1960, and 21 in 1961. On the other hand, only 2 states qualified in 1948 and 1950 and one in each of the three years 1951, 1952 and 1953.

The total excess loss over the whole period 1947-1961 amounted to $2.75 billion, of which 689 million dollars would have been reimbursable under a 25% grant.

(b) A trigger point of 6.5% and grant of 37.5%:

No states were qualified for grants in 1947, 1948, 1955, or 1959.

Fourteen states qualified for grants in 1949, 14 in 1954, 4 in 1957, 21 in 1958, 5 in 1960, and 13 in 1961. On the other hand, only 2 states qualified for grants in 1950 and 1 each in 1951, 1952 and 1953.

The total amount of excess loss for the period 1947-1961 was $2.2 billion; the total amount reimbursable under a 37.5% grant was $831 million.

(c) A trigger point of 7% and grant of 50%:

No states qualified for grants in 1947, 1948, 1952, 1955, 1956, or 1959. Eleven states were eligible in 1949, 11 in 1954, 17 in 1958, and 10 in 1961. Three states were eligible in 1957, 2 in 1960 and 1 each in 1950, 1951 and 1953.

The total amount of excess loss was 1.5 billion dollars; the total amount reimbursable under a 50 per cent grant was 762 million dollars.

(d) Using all 3 trigger points on sliding scale base:

The number eligible is the same as under a 6% rate.

The total amount of excess loss is 2.75 billion dollars (the same as under the 6% rate), the total amount reimbursable, however, is 1.15 billion dollars.

Table 6 shows the amount of reimbursable grants under each trigger point and associated reimbursement rate for six recession years.

TABLE 6

Number of States Eligible in Six Recession Years and Amount of Reimbursable Grants Under Insured Unemployment Rates of 6%, 6.5%, 7% and Sliding Scale

	Number of States Eligible Under				*Amount of Reimbursable Grants Under*			
	6%	*6.5%*	*7%*	*Sliding Scale*	*6%*	*6.5%*	*7%*	*Sliding Scale*
					(Millions)			
1949	18	14	11	18	$133	$192	$225	$253
1954	15	14	11	15	99	143	127	178
1957	6	4	3	6	9	10	7	14
1958	25	21	17	25	343	407	318	558
1960	6	5	2	6	6	8	3	9
1961	21	13	10	21	92	69	82	135
				TOTAL	$682	$829	$762	$1,147

An important feature of the formula is disclosed when the total amounts reimbursable during the recession years 1949, 1954, 1958, and 1960-61 are compared with the total amounts reimbursable for all

years during the period 1947-1961. This comparison is made in Table 7 and shows that regardless of the insured unemployment rate classification, the total amount reimbursable in the recession years amounted to 99 per cent or more of the total amount reimbursable for all years (1947-1961).

TABLE 7

Cumulative Totals of Grants Under Four Rate Classifications for All Years During Period 1947-1961 and for Recession Years

Insured Unemployment Rate	*All Years*	*Recession Years*
	(In Millions)	
6 percent	$ 689	$ 682
6.5 "	831	829
7.0 "	762	759
Sliding Scale	1,156	1,147

Data are presented in Table 8 which indicate the cumulative amounts of reimbursable grants for the period 1947-1961 state-by-state for all states entitled to total grants of five million dollars or more. The states are arrayed in order of the size of the total grants to which each would be entitled under a 6 per cent insured unemployment rate. The data are presented, however, for all states in the table under all four rates—6, 6.5, 7 per cent and sliding scale.

TABLE 8

Cumulative Amounts Reimbursable for Period 1947-1961 Under Insured Unemployment Rates of: *

	(Millions)			
	6%	*6.5%*	*7%*	*Sliding Scale*
New York	$106.6	$159.9	$ 86.2	$181.5
Pennsylvania	106.5	159.7	212.0	212.8
California	97.4	39.9	53.3	124.0
Michigan	90.8	136.2	127.4	168.0
Ohio	62.0	71.1	0	85.7
New Jersey	30.2	38.5	31.5	51.0
Massachusetts	28.5	24.4	32.6	44.8
Connecticut	23.6	35.4	47.2	47.2
Kentucky	16.5	24.8	25.6	31.1
Washington	15.6	23.4	20.1	28.5
West Virginia	15.5	18.7	24.9	28.0
Tennessee	15.2	20.4	23.0	27.7
Oregon	12.4	18.5	12.9	21.8
Rhode Island	11.7	14.7	19.6	21.5
Indiana	10.9	0	0	10.9
Alabama	10.3	14.3	9.1	17.3
North Carolina	8.0	0	0	8.0
Maine	5.4	8.1	10.8	10.8

* States arrayed according to size of reimbursable amount under a 6% rate. No state included having a reimbursable amonnt of less than $5 million.

VIII. Cost of the Proposed Formula

The cost of the proposed sliding scale formula for the entire period 1947-1961 would have been 1,156,402,000 dollars or 0.08 per cent of the 1,477,684,779,000 dollars in taxable wages for the same period.

Without the sliding scale feature, a 7 per cent trigger point with 50 per cent reimbursement would have cost 762,097,000 dollars, or 0.05 per cent of taxable wages. The 6.5 per cent trigger point with 37.5 per cent reimbursement would have cost 830,694,000 dollars, or 0.06 per cent of taxable wages. The 6 per cent trigger point with 25 per cent reimbursement would have cost 688,978,000 dollars or 0.05 per cent of taxable payrolls.

IX. Measuring "Normal Costs" Following a Recession Year

There have been questions as to the possibility of reimbursing some portion of benefit costs solely on the basis of a high rate of unemployment, even though there are no excess losses as determined by the formula. This question introduces a completely different set of considerations which relate to cost equalization rather than reinsurance. If the device which triggers grants is to be solely the unemployment rate, the concepts of "normal costs" and "base period," which are essential to a reinsurance formula, will completely disappear. The formula then becomes in part a cost equalization device. As a cost equalization device, it is too severe. As a reinsurance formula, it is lacking in safeguards against abuse, since a reinsurance formula must bear some relation to normal costs and must be set up in such a way as to avoid reimbursing them.

If a state experiences a qualifying rate of insured unemployment, but has no excess loss, it either (a) experienced high *normal* costs in the preceding year, in which case no reinsurance payment is justified, or (b) experienced *abnormally* high cost in the preceding year, in which case a reinsurance payment was probably paid for the preceding year. In case of (b), if a reinsurance grant was not made for the preceding year, it is to be suspected that a high normal cost pattern prevails. Again, no reinsurance payment for the current year is indicated. But, in the case of two successive years of qualifying rates, it may be desirable to extend the protection of the formula to the second year of recession. This could be done by providing that where a state has had excess costs as defined in the formula in a given year, then it could qualify for reimbursement for a second successive year based upon the difference in its costs for the second year and its costs for the year immediately preceding the first year in which it had excess costs. For example, if T is the base year, $T + 1$ the first recession year, and $T + 2$ the second recession year,

then if a state is eligible in $T + 1$ and has an eligible rate of insured unemployment in $T + 2$ but has no excess loss as measured against $T + 1$, then an alternative base period, T, might be used. This change in the formula would cost slightly more but it would meet much more effectively the needs of states where the progress of recovery was slow.

A significant question at this point is how many states met the trigger point of 6 per cent or more, but failed to have excess costs as measured by the preceding year? Table 9 gives this information.

TABLE 9

Number of States With a Trigger Point of 6 Per cent or Higher Insured Unemployment but Lacking Excess Costs

Year	*Number of States*
1947	0
1948	0
1949	0
1950	8
1951	0
1952	1
1953	0
1954	0
1955	4
1956	2
1957	0
1958	0
1959	5
1960	2
1961	0

It should be noted that states that failed to qualify because of lack of excess costs, did so in the year immediately following a recession year, namely, 1950, 1955, and 1959. The alternative base period discussed above is obviously a suitable modification of the formula in view of these facts.

X. Reserve Fund Level as an Eligibility Criterion

It has been suggested that it be made a condition for receiving reinsurance grants that the reserve fund of the recipient state be below some agreed-upon level with respect to liabilities, the purpose being to conserve reinsurance funds and benefit only those states which are in need. There are a number of reasons why this ought to be opposed. One is that there exists no agreed-upon device for measuring fund adequacy, and there is no hope of formulating a measure which would produce uniform results in all states. Another reason is that such a program of reinsurance might encourage some states to rely on minimal financing efforts. This would surely be the case unless minimum financing standards were enforced.

XI. Safeguards Against Abuse

A note of caution is validly sounded by many persons who want to know what safeguards there are in the proposed formula to prevent a state's liberalizing its benefits at the expense of the reinsurance program. The existence of a base period for determining "normal" costs is the safeguard. In the first place, the cost of liberalizing a benefit formula will become "normal cost" within a very short period (not longer than two years) under the proposed reinsurance formula. This means that the period of time to which this question relates is very short and the likelihood of its affecting the reinsurance program is correspondingly slight. In the second place, the higher benefit costs will become partly reimbursable only when high unemployment rates are experienced. This precludes deliberate abuse. On the other hand, reinsurance is needed to assist a state which may have enacted liberalizations at an inauspicious time with reference to financing. And, in the third place, a state would in any event have to meet at least half the burden of higher costs from its own fund.

XII. Reinsurance and Extended Benefits

There is also the problem of state-financed extended benefit programs. Should reinsurance cover these benefits in whole or in part, or not at all? In replying to this question it is necessary to distinguish carefully between extensions of benefits through liberalizations of regular state benefit formulas and the extension of benefits under recession-triggered special programs. In the former case, full reinsurance coverage should apply for reasons discussed above. In the latter case, there are two principal reasons why extended benefits should be wholly excluded from reinsurance protection. One reason is that since extended benefits and reinsurance eligibility would be triggered-in almost concomitantly, there would be no cost experience in the base period to compare with that in the current period. In short, there is no measure of "normal" costs and all extended benefit outlays would become "excess loss." The reinsurance fund is thus abused by being made the vehicle for financing part of a state's benefit extension program. A second and related reason is that the enactment of programs of benefit extension is discretionary and they should not be undertaken unless they can be adequately financed out of state funds. Also, it is exceedingly unlikely that any reinsurance plan will be adopted prior to the initiation of a nationwide program of regular extended benefits, the financing of which will probably be from a revision of the Federal Unemployment Tax Act.[24] It is not

24. Int. Rev. Code of 1954 §§ 3301-08. Note provision for this in the McCarthy-King Bill, *supra* notes 15 & 17.

needful, therefore, that the application of reinsurance to other than regular state benefits should be considered.

XIII. How Should Reinsurance Be Financed?

There is a strong argument for federal financing of reinsurance. The risk involved in reinsurance is related to recession, or mass unemployment. It is a risk which is unpredictable, may develop very suddenly, and may cause heavy drains on state reserves. Furthermore, it is nationwide in scope and wholly outside the control of any employer or state.

It is obvious that there is a very important national interest in the alleviation of the burden of recession unemployment. This has been manifested many times by Congressional legislation. The logic of the situation points to the need for federal cooperation in the case of this proposal.

It is recommended, therefore, that funds adequate to finance a reinsurance system be provided by a uniform federal tax levied on all state taxable payrolls and that funds collected by this tax be accumulated in a special fund designated as the Reinsurance Fund. Grants would be made to the states by the federal government as they become eligible.

It would seem that a plan such as this has decided advantages over cost equalization. First, every state could benefit from this plan since all are exposed to the risk of heavy drains in recession periods. Second, no state would be called upon to share in the costs of those states which have normally high and persistent benefit cost rates. Third, there should be much less political opposition to this plan than exists towards cost equalization since this proposal simply involves paying an insurance premium of low cost to protect against an unusual and unpredictable hazard. Finally, this proposal does not involve any requirement relating to benefit standards.