



FIXING MASSACHUSETTS' UNEMPLOYMENT INSURANCE SYSTEM

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EXECUTIVE SUMMARY

Amid the economic fallout from Covid-19, unemployment insurance (UI) has proved a vital part of Massachusetts' social safety net. Not only have unemployment benefits aided laid-off workers, but when recipients spent those benefits at area businesses it helped stabilize the state economy and bolster state tax revenues.

At the same time, the pandemic has exposed serious shortcomings in Massachusetts' unemployment insurance system.

Having failed to set aside sufficient money to cover benefits, the state has been forced to take large loans from the federal government — loans that will ultimately have to be repaid by Massachusetts businesses. And even if we can ease repayment, as the governor has proposed, more fundamental fixes may be needed to avoid future borrowing and ensure our unemployment insurance program is ready for the next inevitable downturn.

Looking at the urgent needs of the moment as well as long-term challenges, we find that:

- Without legislative action, UI tax rates on employers are set to increase substantially this year. Now may not be the optimal time to raise rates, given the ongoing struggles of many Massachusetts businesses. Instead, a temporary tax freeze may be necessary.
- Repeatedly freezing unemployment insurance taxes — as Massachusetts has done for much of the last decade — is a recipe for long-term insolvency and future debt. To avoid this, a short-term freeze could be paired with longer-term changes aimed at building up reserves during good economic times, such as automatic UI tax increases when unemployment is low.
- Massachusetts' unemployment insurance system virtually guarantees funding shortfalls. While benefits are designed to keep up with wages, taxes are not, so over time the needs of the system steadily outstrip contributions. A simple fix would be to index the taxable wage base so that UI taxes automatically track overall wage growth; this change would also limit the extent to which small, low-wage businesses subsidize large ones.
- Adding a tax on employees — as is done for Social Security and Medicare — could generate much-needed funding and also improve the political dynamics of unemployment insurance, giving workers a

stronger sense of their dual role as beneficiaries and contributors.

- Massachusetts does offer some UI benefits that seem out of line with the rest of the nation. For instance, we are the only state that provides support for more than 26 weeks, and our system is open to workers with relatively little recent work history. Despite these controversial provisions, typical benefits in Massachusetts follow the broad rule of thumb that unemployment insurance should replace about half of lost wages.
- Businesses with a history of layoffs pay higher UI tax rates. However, the maximum tax rates may still be too low to ensure that all businesses are really paying their fair share.

The sections that follow include a primer on the unemployment insurance program, an account of the current dilemma facing Massachusetts, a summary of the governor's proposed solution, and a detailed consideration of the long-term challenges and potential remedies.

UNEMPLOYMENT INSURANCE: A QUICK PRIMER

Unemployment insurance is a New-Deal-era program that provides temporary, partial wage replacement for workers who have lost their jobs through no fault of their own and who continue to seek employment.

Over time, it has also been recognized as a powerful tool for fighting recessions, putting money into the pockets of those most likely to spend it and generating much-needed economic activity.¹

From the beginning, unemployment insurance has been a partnership between the federal government and the states, with Washington establishing broad rules and guidelines, paying administrative costs, and providing supplementary benefits during economic downturns. The federal government also sets up savings accounts for each state, with interest and borrowing rules that reward long-term thinking and good financial stewardship.

It is the states, however, that fund most of the benefits going to workers. States also get to decide who is eligible and how much they should receive.

Funding comes chiefly from a tax on employers, with a unique arrangement where rates are highest for business with a history of layoffs leading to unemployment insurance claims. This approach is known as “experience rating,” and it ensures that the businesses that put the greatest strain on the UI system also contribute the most (though not their full share, as discussed below.)

In Massachusetts — and many other states — the tax rate on businesses also changes based on the health of the UI savings account overseen by the federal government. When the state has lots of money set aside, the rate goes down; when the account is low (or negative), rates go up.

The stability of the system as a whole depends on “forward funding,” where states build reserves in good times so they can pay benefits when unemployment spikes during recessions.

Unemployment insurance taxes are relatively small compared to other payroll taxes such as Social Security, Medicare, and worker’s compensation. In 2019, unemployment insurance taxes amounted to 0.47 percent of wages across the United States, meaning 47 cents for every \$100 paid in wages. In Massachusetts, it was 86 cents for every \$100. For Social Security, employers pay a tax that is more like \$5 for every \$100 in wages.

Still, because unemployment insurance taxes change regularly, and sometimes in big jumps, they can have a sudden, unexpected impact on business finances.

URGENT CHALLENGES AND OPTIONS

The widespread job losses wrought by Covid have drained Massachusetts’ unemployment insurance savings account and forced the state [to borrow \\$2.2 billion from the federal government](#). Interest on that loan will start accruing this year. And unless the state can repay the full amount by fall 2022, the federal government will [automatically raise taxes on Massachusetts employers](#).

What’s more, the state projects that this debt to the federal government will [continue to grow](#) through 2021 and 2022.²

Ultimately, the burden of this debt falls not on the state but on local businesses and workers. That is because the system is entirely funded by dedicated business taxes (and economic research suggests those business taxes [ultimately reduce workers’ paychecks](#).)

Options

Under current law, this level of underfunding automatically triggers an increase in unemployment taxes for Massachusetts businesses.

However, with the cloud of Covid still hovering, and small businesses continuing to struggle, now may not be an optimal moment to raise UI rates. Instead, the state has a few choices.

Massachusetts could dedicate some federal Covid relief money to pay off our unemployment insurance debt, [as other states have done](#). This approach would violate the lockbox principle that unemployment insurance benefits should be paid via business taxes — and never with general revenue. But in these extraordinary times, state money could be considered an economic aid program for businesses.

Alternatively, the state could choose not to address the debt at all, as other states have done in similar circumstances. In that case, the federal government would solve the problem by automatically raising federal unemployment insurance taxes on Massachusetts businesses until all arrears are repaid.

Or, finally, the state could ease the debt burden by spreading it out over time. Swapping the current debt — which needs to be repaid relatively quickly — for longer-term bonds would allow employers to repay their UI debts over the course of decades, rather than years. This is the approach proposed by Governor Charlie Baker.

The Governor's Bill

Under the governor's proposal, the state would issue bonds covering not only the current UI funding shortfall but any additional shortfalls through 2025. This would "zero out" our account with the federal government, thus forestalling additional interest payments and eliminating the risk of a federal tax increase on employers.

Business would still be responsible for the more than \$2 billion in unemployment insurance debt. But instead of having to repay the federal government over the course of a few years, they could repay bondholders over as many as 30 years.³

Under this proposal, businesses would be responsible for several kinds of unemployment insurance taxes moving forward:

- The first tax is the one we already have, designed to sustain our unemployment insurance system. Rates on this tax would be frozen for two years.

- The second tax would be dedicated to paying off the governor's proposed bonds.
- The third, a two-year surtax, would repay any interest already accrued by the time this plan takes effect.

All three of these new, parallel UI taxes would have a similar structure, including an experience rating approach to ensure that employers that lay off the most workers pay the highest rates.

By turning a single unemployment insurance tax into three separate levies, the governor's plan would create some new accounting complexity, which can be tricky for smaller businesses. With a tweaked approach, it might be possible to combine the tax on interest with the tax on bonds, so that the new UI structure would have just two taxes.

More important, using bonds to spread payments over decades raises fairness concerns, as it means that some of today's debt will ultimately be repaid by businesses that don't exist yet — while businesses that close or move in upcoming years could avoid contributing. It also means businesses will still be paying off bonds during future economic downturns, when such surtaxes are especially undesirable.

LONG-TERM CHALLENGES AND OPTIONS

Even the best plan to address today's urgent needs would leave the state vulnerable to ongoing emergencies and future failures, unless it resolves the deeper problems afflicting the UI system.

(In)Solvency

Massachusetts was particularly ill-prepared for the skyrocketing jobless rates of 2020 because our UI program was already underfunded.

To assess whether states have set aside enough money, the federal government has a favorite test. It simply asks: Would the state's reserves cover an

typical “bad” year — technically, the average of the three recent years with the highest benefit payouts.

On this core measure of solvency, Massachusetts had the [fifth-lowest score in the country](#) in 2019, with just 42 percent of the funds needed. The last time the state passed this test was 20 years ago.

One reason Massachusetts has chronically underfunded its unemployment insurance account is that the state hasn’t followed its own standards for when to raise and lower taxes. We have statutes calibrated to create a healthy reserve by triggering automatic tax increases when savings are small and reducing rates when savings are adequate.

Not once between 2010 and 2019 were rates set according to this law. Instead, they were regularly frozen or otherwise constrained by lawmakers.

There are times when this “manual override” makes sense, like the years immediately following the Great Recession — or today. But for most of the last decade, the economy was strong enough to support higher rates.

Options

It is not enough to say that current law should simply be followed, because the tax triggers are not well designed.

Among other things, they require tax increases when the UI savings account is low — which often happens during or shortly after a recession, when business budgets are still under significant stress.

It might make more sense if tax increases were triggered by some combination of low savings and economic health. As an example, rates could be automatically frozen when joblessness is high (e.g., if the unemployment rate is over 7 percent for 9 of the last 12 months.) Once the job market recovers, rates could rise to rebuild reserves.

Alternatively, increases could be limited to a single step in the rate schedule (from Schedule E to F but never from E to G). This, too, would help limit sudden tax increases at inopportune times.

Changes like these could help align UI taxes with economic conditions, ensuring that state employers are better positioned to absorb tax increases when they arise.

Simulations would need to be run to confirm that these additional conditions still allow the state to fully replenish its trust fund over the course of an economic cycle.

Controversial Benefits

Massachusetts offers some of the largest unemployment insurance benefits of any state, for good reason. The core goal of unemployment insurance is to replace a share of lost wages — 50 percent is the standard rule of thumb. As a consequence, benefits tend to be larger in states where wages are higher, and Massachusetts workers earn among the highest wages in the country.

On average, unemployment benefits in Massachusetts [replace 48.5 percent of lost wages](#), which is slightly above the national average of 45 percent but below the replacement rates of 20 other states.

Still, the Massachusetts system does have some controversial eligibility rules and benefits that could be addressed as part of a broader package.

Options

Massachusetts is the only state where benefits can continue beyond 26 weeks — up to 30. Hewing to that 26 week maximum would bring Massachusetts in line with peers.

Alternatively, if the goal is to provide extended benefits in challenging labor markets, the 30 week maximum could be made available in times of high unemployment (e.g., above 7 percent for 9 of the last 12 months).

Capping benefits at 26 weeks would likely have a limited impact on overall costs. About 10 percent of recipients in Massachusetts receive benefits beyond 26 weeks; and even among that 10 percent, the bulk of total UI benefits are collected before the 27th week. As a consequence, a 26-week maximum would reduce spending by at most

1.5 percent. However, there could be indirect savings too — for example, if a 26-week maximum [encouraged recipients to accept job offers more quickly](#).

Separately, Massachusetts offers unemployment benefits to workers with little time in the labor force. Many states require applicants to have earned money in at least two quarters; others have formulas that reduce payments for applicants with shorter work histories.

It's unclear exactly how Massachusetts' openness to applicants with limited work experience affects overall spending. Generally speaking, these claimants are eligible for smaller benefits; but there could be many such claimants, which would raise total costs.

Any effort to reform these provisions should be based on a fuller accounting of the potential impact and savings.

Poor Tax Design

Long-term funding deficits are virtually inevitable in the Massachusetts UI system due to the fundamental disconnect between benefits, which automatically keep up with wage growth, and tax payments, which don't.

The core problem is that employers only pay UI taxes on the first \$15,000 that their workers earn each year. This ceiling, referred to as the "taxable wage base," has some distorting effects.

Notice that \$15,000 is a pretty low figure, given that median earnings in Massachusetts is [closer to \\$50,000 a year](#). This creates a disproportionate burden for businesses that rely on lower-wage workers, including many small businesses.

To see why, imagine two businesses: John's Restaurant and Jane's Investment Company. At John's Restaurant, the typical employee might make \$30,000 a year, which means John has to pay unemployment taxes on half of each worker's earnings — and half of his total payroll. At Jane's Investment, however, the typical employee might

make \$150,000 per year, in which case Jane pays taxes on only 10 percent of her total payroll. That makes unemployment insurance much less onerous for Jane.

And there's another problem with the \$15,000 taxable wage base: It's fixed in statute, rather than adjusting for inflation or wage growth, which makes a big difference over time, as wages tend to rise 3-4 percent each year.

To return to our example, 10 years from now John's Restaurant might be paying employees \$45,000 each. Yet he will still be paying unemployment taxes on just the first \$15,000 of their earnings. And that's terrible news for the state's unemployment insurance system as a whole because it means John is paying the same amount in taxes while his employees are eligible for higher benefits (roughly half of their now-higher weekly earnings.⁴)

This failure to index the taxable wage base helped drive down the actual tax rate paid by employers (total taxes paid / total wages paid) from 1.16 percent to 0.86 percent between 2010 and 2019.

Options

Index the taxable wage base. The most straightforward way to balance taxes with benefits is to annually adjust the taxable wage base to reflect wage growth. Not only would this eliminate the built-in bias toward underfunding, but it would help prevent big jumps in the tax rate schedule by supporting solvency in another way.

Across the country, states that index their taxable wage base have an easier time [replenishing their UI savings accounts after recessions](#), meaning that this change could help Massachusetts restore solvency in the coming years.

Raise the taxable wage base. A different change is required to address the fact that UI taxes place a disproportionate burden on smaller, lower-wage businesses. For that, the taxable wage base could be increased from \$15,000 to something more like \$30,000 or \$40,000, in line with other states that have made this change. Note that this adjust-

ment needn't be a tax hike; it could be made in a revenue-neutral way by reducing tax rates at the same time.

Do both: raise and index the taxable wage base.

These changes work well together, and several states have pursued them as a package.

Introduce a tax on employees. There is a sound argument — with research behind it — that workers actually pay the unemployment insurance tax because [businesses pass the tax along in the form of lower wages](#). If so, it might be beneficial to recognize, and formalize, this hidden contribution from workers by converting some part of UI taxes into a direct tax on workers.

This is how Social Security and Medicare taxes work — some part is paid by the employer, some by the employee — so there is good precedent for this approach. And three states already use employee taxes to help fund unemployment insurance.

One potential benefit could be a shift in political dynamics. In the current setup, workers tend to defend the benefit side of the program while employers fight to limit tax increases. That means the only way for both sides to win is chronic underfunding (benefits stay strong, funding stays low). With a tax on employees, workers would straddle both sides of this divide, as payees and beneficiaries, giving them more incentive to find solutions that strengthen the system as a whole.

A tax on employees might also raise awareness about the availability of unemployment benefits. And any stigma currently attached to these benefits would be reduced if employees started thinking of unemployment insurance the way they think about Social Security — as an account they funded and can freely draw on.

Bad Actors and Experience Rating

By design, UI tax rates are higher for businesses with a history of laying off workers who claim unemployment benefits. That is a core principle of the American system across all 50 states, and the technical term for it is “experience rating.”

However, once an employer gets labeled as extremely likely to lay off employees — and hit with the highest tax rate — [there is no additional disincentive](#). That employer can now lay off workers with impunity, having no fear of higher taxes because there are no higher rates.

A gap thus opens up between the amount contributed by employers with the worst rating and the benefits paid to their laid-off employees. In Massachusetts, that gap is fairly large, putting us in the top quarter of all states in 2019 and suggesting some businesses are contributing far less to the UI system than their employees ultimately draw out.

The flip side of this is true as well. Employers who rarely — or even never — let go of workers face a minimum tax rate that ensures they contribute more than their employees will ever collect.

Options

A wider range of rates. Introducing additional, higher tax rates for firms whose workers have a history of claiming UI benefits would diminish this concern, creating a better match between what individual employers contribute and what their laid-off employees actually claim.

Higher rates for high-layoff firms could also blunt concerns that seasonal businesses and project-focused sectors (like construction) strategically lay off employees during slow times of year — expecting the unemployment insurance system to keep workers whole until busier times return.

There is, however, a risk in raising top rates: Instead of encouraging businesses to hold on to workers, it could create a perverse incentive for businesses to block laid-off workers from justly claiming unemployment benefits — either by failing to inform workers about their rights or by contesting claims.

A more flexible approach to rate-setting. Alternatively, some states are opting for a new approach known as [“array allocation,”](#) which allows for a wider spread of tax rates — and also a better fit between employer payments and the needs of the system as a whole.

Under array allocation, tax rates and experience rating cutoffs are not set in statute. Instead, the state reapportions them each year to ensure that total taxes remain reliable, adequate, and fairly applied across employers with very different histories.

More responsive experience rating. The system Massachusetts uses — called reserve ratio experience rating — doesn't respond quickly to employer behavior, meaning that if a particular business becomes more likely to lay off workers, their tax obligations could take years to adjust. A different approach, called benefit ratio experience rating, adapts more quickly to changes in employer behavior and [seems to help states maintain solvency](#).

Future Fraud

In 2020, unemployment insurance systems were stressed like never before by the combination of widespread unemployment and emergency add-on programs.

Quickly processing an unprecedented volume of claims (with new eligibility rules!) helped millions of Americans survive the worst of the pandemic recession. However, it also created new opportunities for fraud, with tales of sophisticated scams and well-organized fraud rings [all across the country](#).

Given the urgency of pandemic assistance, preventing all such fraud was an impossible task. But as the economy recovers, and the UI program resumes its former, calmer operations, it will be important to fortify the system against future manipulation.

Options

A thorough audit of the performance of Massachusetts' unemployment system under Covid — including a forensic analysis of suspicious patterns among claims and the investigation of particular incidents — could help identify and address vulnerabilities.

Looking ahead, it might be valuable to combine this audit with a report on [potential operational and IT](#)

[improvements](#) to boost security and smooth the process of claiming and receiving benefits in future.

Additional Groups

Over its 80-year history, the unemployment insurance program has not always kept up with changes in the American economy. Adapting the program to the 21st century workforce could strengthen its impact.

Gig workers

Traditionally, the unemployment insurance program is limited to formal employees, not independent contractors or gig workers. That changed under Covid, when the federal government offered unemployment benefits to some nontraditional workers, but only on an emergency basis.

Finding a way to integrate gig workers into the unemployment insurance system will be tricky because by definition they have no employers to pay taxes on their behalf — or to confirm that they have been laid off.

One approach, already underway, is to crack down on businesses that misclassify employees as independent contractors, as those workers would then be integrated into the existing system.

More generally, an employee-side tax would make it easier for gig workers and independent contractors to enjoy the protections of unemployment insurance, as they would be helping to fund their own benefits — much as they do with Social Security (see “Poor Tax Design.”)

However, this is a major, national challenge that may require national leaderships to address.

Unauthorized immigrants

While unauthorized immigrants are ineligible for most safety net programs — including unemployment insurance, Social Security, food stamps, and Medicaid — there are some exceptions. In many states, unauthorized immigrants can claim worker's comp, and the children of unauthorized immigrants can attend public schools.

Whether or not Massachusetts considers allowing unauthorized immigrants to claim unemployment benefits, it is worth noting that some employers are [already contributing to the UI system](#) on behalf of these workers.

Self-insured nonprofits

Nonprofit organizations don't necessarily pay unemployment insurance taxes; instead, they can choose to self-insure. In that case, they are still responsible for covering claims by their laid-off employees, only they do so via ex-post reimbursements rather than up-front taxes.

While this arrangement has worked well in normal times, it has been strained by unprecedented layoffs in the nonprofit sector during Covid.

Advocacy work is underway at the state and federal level to resolve this immediate challenge, but it may be worth considering longer-term changes to address future risk, be it greater oversight of self-insurance arrangements (including pooling mechanisms like trusts) or incentives to encourage participation in the regular state unemployment system.

fails to ensure that taxes automatically keep up with wages, and subsidizes employers that lay off the most workers.

In the near term, the state needs to address its \$2.2 billion debt to the federal government. But without a broader package of changes, it is not clear Massachusetts' unemployment insurance system can maintain solvency and ensure adequate benefits.



CONCLUSION

Economic life is rarely smooth. Sometimes individual workers lose their jobs; sometimes whole businesses go bankrupt; sometimes entire economies collapse.

The unemployment insurance system is meant to protect against all of these, providing benefits to folks who lose their jobs and much-needed stimulus for struggling economies.

But in order to provide money in bad times, Massachusetts needs to put some aside in good times.

Right now, our unemployment insurance system is not set up to accomplish this. Among other things, it triggers tax increases at inopportune moments,

Endnotes

¹ Unemployment insurance has another benefit for workers: it gives them the freedom to decline bad job offers and [wait for better matches](#).

² cSPA's own projections suggest that employment will rebound faster than the state assumes, generating less total debt for the unemployment insurance system.

³ Another possible benefit would be lower interest rates on the bonds, but that is not entirely certain. See "[A Comparative Analysis of Unemployment Insurance Financing Methods](#)" for a fuller description of the trade-offs.

⁴ After accounting for inflation, it is more accurate to say that John's future workers would be getting a little bit more in benefits (nominal wage growth minus inflation) while employers would actually be paying lower taxes, in real terms.

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