

Understanding the Unemployment Trust Fund Crisis of 2010

INTRODUCTION

After two years of recession, the U.S. labor market remains in extreme distress. Most economists expect unemployment rates to remain near 10 percent throughout 2010 and the administration predicts that unemployment will continue to average over 9 percent in 2011 and over 8 percent in 2012.¹ Long-term unemployment is at record levels with the average duration of unemployment lasting over six months. One result of this distressed labor market is unprecedented federal borrowing by state unemployment insurance (UI) trust funds to maintain payment of state UI benefits.²

As of April 2010, 33 states and the Virgin Islands had drained their state UI trust funds and been forced to borrow from the federal government in order to continue paying state UI benefits. Borrowing will rise as weak labor markets persist in coming years. Actuaries at the U.S. Department of Labor are projecting that as many as 40 of the 53 UI jurisdictions could borrow over \$90 billion in federal loans for state trust funds by FY 2013.³

The purpose of this briefing paper is to provide an overview on the subjects of UI financing and solvency that is understandable to the advocate or policy maker who does not specialize in this area. While this paper attempts to minimize the use of overly technical terminology, readers need to be aware that the subject matter is somewhat complex and does involve some

terms of art that are specific to the world of unemployment insurance financing. We recommend that readers new to the subject turn now to our Thumbnail Explanation at the end of this briefing paper for a more detailed introduction.

I. UNEMPLOYMENT INSURANCE FINANCING 101

A. State UI Solvency in Early 2010

Although UI financing has garnered recent attention as state borrowing has spread during the current recession, for the most part, federal and state policy makers and other observers are only starting serious reviews of UI financing options. The dramatic spike in unemployment claims activity during the past two years has accelerated trust fund insolvency in many states that were far less prepared to withstand the current recession than they were prior to previous economic downturns.

Increased unemployment hurts UI solvency in two ways. First, as unemployment grows more serious, the number of UI claims rises and the duration of benefit payments lengthens. In turn, these changes increase payments of UI benefits. Second, wages subject to state UI payroll taxation disappear as businesses fail and workers are laid off. Since jobs are disappearing and jobless workers are not earning wages, state UI payroll tax collections fall or slow while benefit payments rise at the same time.

This one-two punch can be seen in recent state UI program statistics collected during this recession. For example, total regular state UI benefit payments rose from \$32.9 billion in 2007 to \$43.5 billion in 2008, and skyrocketed to \$80 billion in 2009. Current unemployment levels brought an unprecedented surge in the number of UI claimants nationally. Between 2007 and 2009, the average number of initial claims filed each week increased by 75.6 percent — up from about 321,000 per week in 2007 to 564,000 per week in 2009. On the employment side of the equation, the number of covered employers subject to UI taxes fell from 132.5 million in the third quarter of 2008 to 127.4 million by the third quarter of 2009.

Rising UI benefit payments and declining taxable employment have taken a toll on states' overall UI solvency during 2008 and 2009. States ended 2007 with \$38.3 billion in overall reserves, falling to \$29.9 billion by the end of 2008, and dropping to only \$14.2 billion by the end of September 2009. As of April 2010, 33 states and the Virgin Islands had trust funds that were insolvent and had borrowed in excess of \$38.8 billion in federal loans.⁴ Of these 34 borrowers, 12 states have already borrowed over \$1 billion each. California has borrowed over \$8.4 billion and Michigan has a federal loan of over \$3.7 billion. The U.S. Department of Labor is projecting that by the end of 2013 as many as 40 states will face insolvency with total state borrowing of \$90 billion.

Unquestionably, a major cause of record levels of state borrowing is the unprecedented loss of jobs, the pace of job losses, and length of this labor market downturn. The rate and extent of job losses in the current recession exceed those found in all previous post-1970 U.S. recessions.⁵ But these trust fund problems have been greatly exacerbated by the neglect of sound financing principles before the recession began. If these problems are not addressed, state programs may not recover their ability to deliver an adequate safety net.

B. Essential Background and Concepts in UI Financing

Understanding how we got into our current UI solvency dilemma requires some basic background and concepts of UI payroll taxation and solvency. While recognizing our terrible labor market's significant role in UI insolvency, constructing an effective policy response requires a deeper examination of the history and policies that have likewise contributed to our UI solvency problems.

1. Decline in wages subject to taxation. A major shortcoming in both state and federal UI financing is that only a small portion of wages, called the *taxable wage base*, are subject to UI payroll taxation. As a consequence of having mostly fixed taxable wage bases combined with growing weekly benefits levels, the ratio of taxable wages (those wages covered by state taxable wage bases) to total wages (those wages paid to covered employees) has declined significantly. Nationally, the ratio of taxable wages to total wages was 0.447 in 1980; it reached 0.376 in 1990, fell to 0.305 in 2000, and stood at 0.272 in 2008. In other words, as a consequence of low taxable wage bases, just over a quarter of wages covered by UI laws nationally are subject to state UI payroll taxes. This decline is illustrated by Figure 1.

Both the state and federal components of UI programs have failed to keep taxable wage bases in line with the growth in wages, contributing to our current UI financing challenges. Congress sets a *federal* taxable wage base that is the minimum *state* taxable wage base as well. This federal taxable wage base was set at \$4200 from 1972 through 1977, \$6000 from 1978 through 1982, and has been only \$7000 since 1983. In comparison, the federal Social Security taxable wage base is \$106,800 in 2010.

2. Federal unemployment taxes. The federal government imposes a separate federal UI payroll tax, known as the FUTA (Federal Unemployment Tax Act) tax. This tax is the mechan-

ism that ensures that all states have unemployment insurance programs that meet certain minimum federal standards. If a state has a UI law that meets federal requirements, as all states do, then its employers pay a reduced FUTA tax. For over 30 years, this tax has been 0.8 percent. This tax is imposed on a federal taxable wage base of \$7000, resulting in an annual federal UI tax of \$56 per employee. FUTA tax revenues pay for UI extensions, federal trust fund loans to states, and UI administration by both the U.S. Department of Labor and state UI agencies.⁶

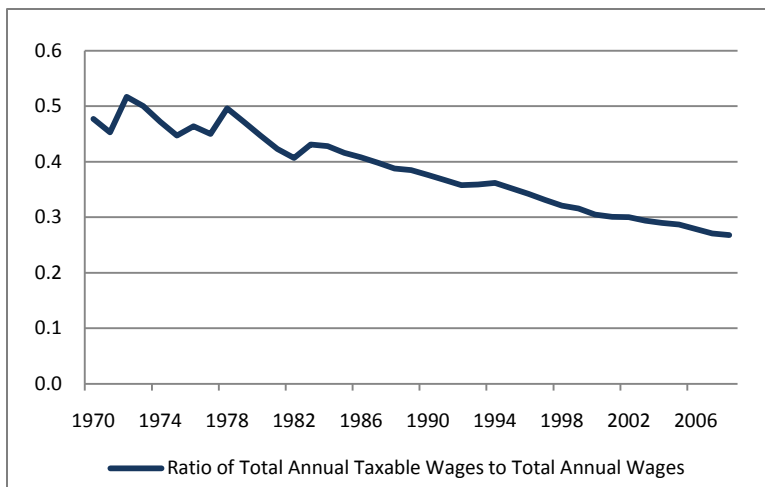


Figure 1. Ratio of Taxable Wages to Total Wages, 1970-Present

3. Taxable wage base. Regular UI benefits are financed by state payroll taxes paid by employers.⁷ As noted, state UI taxes are imposed on a state *taxable wage base* that ranges from a federally imposed minimum of \$7000 in four states to over \$25,000 a year in nine states. The large majority of states have state taxable wage bases of \$12,000 or less. Sixteen states automatically adjust their state UI taxable wage bases upwardly based on the growth of state average wages (called “indexed” taxable wage base). States with indexed taxable wage bases have higher taxable wage bases than those without indexing.

Writing in the late 1990s, economist Philip Levine focused on fixed taxable wage bases as a key factor in UI financing. “A major deficiency in

the current system of UI financing is that the infrequent, ad hoc adjustments to the taxable wage base lead to a continual erosion of its financial stability. . . . Even in the absence of severe cyclical downturns, these basic relationships indicated that the current system of UI financing will drift toward insolvency.”⁸ For the most part, this description by Levine is an accurate assessment of UI financing trends over the past three decades as states drifted (and, at times swam) toward insolvency.

The central role of the taxable wage base can be seen in recent trends. Most states currently in debt or approaching debt have a history of low taxable wage bases combined with low maximum tax rates. Of the 33 states and the Virgin Islands that are currently insolvent, 20 have a taxable wage base of \$10,000 or less and 26 have taxable wage bases that are less than \$15,000. By contrast, of the 13 states likely to remain solvent during 2010, 10 states have an indexed taxable wage base. Over the past decade, these states have avoided raising taxes significantly and/or pressures to cut benefits when workers and employers could least afford it.

4. Experience Rating. Another unique feature of UI financing in the U.S. is that state UI tax rates are determined in part by *experience rating*. While UI experience rating mechanisms differ from state to state, they are designed to impose higher taxes on employers with more layoffs. In simple terms, employers that have higher UI claims filed by their former employees will pay higher taxes in future years to repay these higher costs. In addition, as trust fund levels fall, most state laws include special solvency mechanisms that are triggered by falling trust fund balances and will impose a somewhat higher tax on all employers to maintain trust fund levels. As a result of experience ratings, state UI payroll taxes are rising in 2010.⁹ In addition, a few states have adopted higher taxable

wage bases or higher tax rates, above and beyond automatic changes. These tax changes have been made in reaction to falling trust fund levels.

C. ABCs of UI Solvency

Evaluating the sufficiency of UI trust funds involves an assessment of the “solvency” of UI trust fund balances — basically a judgment about the level of reserves required to meet UI benefit payments in a future downturn.¹⁰ There are two basic ways to assess UI solvency — looking forward and looking backward.

Comparing trust fund reserves to each state’s total wages is a way to measure trust fund balances against the amount of a state’s wages. Total wages are essentially a measure of the risk being insured by UI because lost wages are the insured risk. So, comparing trust fund balances to wages is a way of looking forward at the potential size of claims against the trust fund. The fraction of trust fund reserves to state wages is commonly known as the “reserve ratio.”

The other common measure of solvency compares the size of trust fund reserves to past benefit payouts during recessions. Termed a “cost multiple,” this measure of solvency uses past performance to assess the adequacy of current reserves by comparing trust fund reserves to historically high UI benefit payment levels in prior recessions. The resulting multiple is calculated in such a way that 1.0 is equal to one year of reserves at historic levels of high benefit payments — and this measure has been widely recommended by UI financing experts as the appropriate level of pre-recession reserves. The most common measure of this type used today is called the “average high cost multiple” or AHCM. As you can see from Figure 2, states entered this recession less prepared than they were prior to any of the other recent recessions.

There was a steep decline in trust fund preparedness at the onset of the last recession at the end of 2000 (30 states) compared to the outbreak of the current downturn at the end of 2007 (just 19 states).

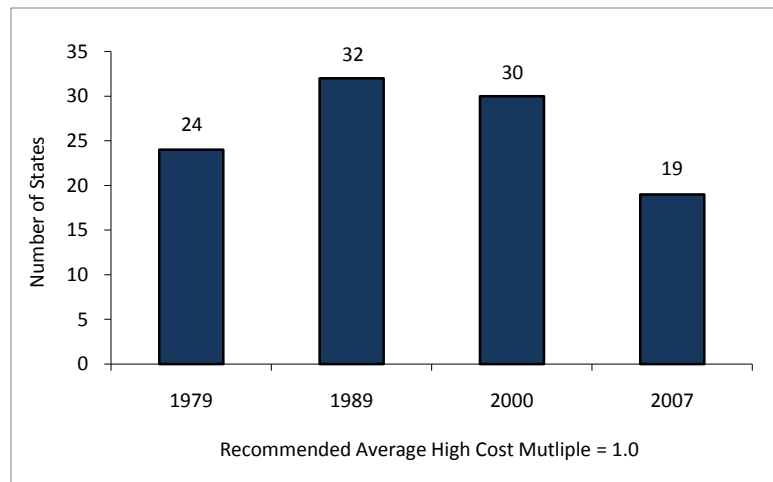


Figure 2. States Holding Recommended Trust Fund Savings at the Start of Recent Recessions

D. Forward Funding Key for UI’s Role as an Economic Stabilizer

The twin goals of unemployment insurance are the payment of adequate, temporary wage replacement to involuntarily unemployed individuals and the stimulation of economic activity by maintaining consumer spending. Wayne Vroman, the nation’s leading authority on UI financing, summarizes the overall economic theory supporting forward funding of UI programs:

Trust fund balances are built up before recessions, drawn on during recessions, and then rebuilt during the subsequent recoveries. The funding arrangement implies that the program acts as an automatic stabilizer of economic activity, that it makes larger benefit payments than tax withdrawals during recessions and larger tax withdrawals than benefit payments during economic expansions.¹¹

Obviously, paying adequate benefit levels to a reasonable proportion of jobless workers translates to making state UI programs more effective countercyclical mechanisms. The contrasting approach to UI financing — sometimes termed “pay as you go” — keeps UI payroll taxes and trust fund levels as low as possible during economic good times and then raises taxes and cuts benefits due to financial stress during recessions. This approach turns the UI program on its head, completely undercutting the goal of economic stimulus. Encouraging forward funding of UI trust funds is essential if our UI program is going to serve as a more effective economic stabilizer in future recessions. And, moving UI programs back toward forward financing will require significant changes in federal and state UI financing policies.

II. HISTORY OF UI SOLVENCY

A. A Recent History of UI Taxes, Benefits and Trust Funds

Figure 3 tracks the rate of unemployment insurance taxation over the last three decades, as UI contribution rates fell from nearly 1.5 percent of wages in 1983 to just 0.5 percent of wages by 2001. Steep declines occurred as a

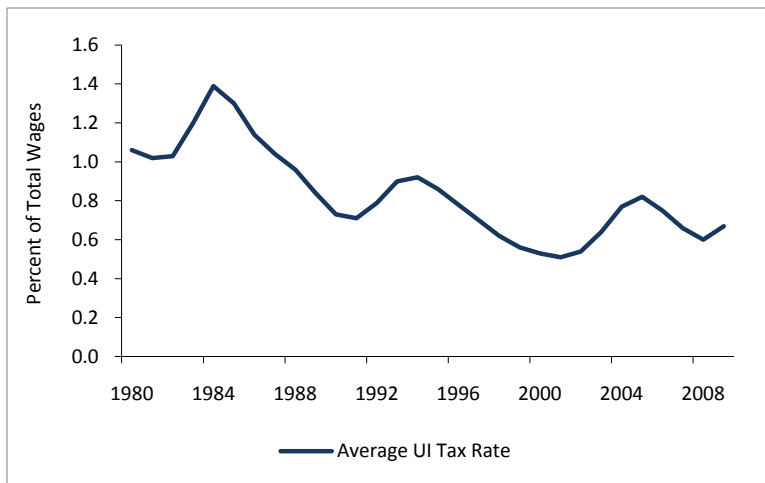


Figure 3. Unemployment Tax Rates have Dropped Precipitously in the Last Three Decades

result of the 1990s-era tax cuts, with taxes dropping from over 0.9 percent of wages in 1994 to the low point of 0.5 percent in 2001. After the 2001 recession, the average tax rate paid by employers rose to 0.8 percent in 2005, mostly as a result of the automatic impact of state experience ratings and modest solvency legislation in a few states. Once the economy began to expand, tax rates quickly dropped back to the low level of 0.6 percent in 2008 and were still below 0.7 percent in 2009.

Table 1. National Unemployment Insurance Reciprocity

Year	Percentage	Year	Percentage
2000	38	2005	36
2001	44	2006	36
2002	43	2007	37
2003	41	2008	37
2004	37	2009	41

Certainly, less revenue has been coming into the system in recent years. Are overly generous benefits payouts also to blame for the steady march to insolvency? The evidence indicates that the answer is no. Among the 34 insolvent jurisdictions, benefits for workers have not grown dramatically over the last ten years. Weekly benefit amounts have increased slightly, yet some states have failed to increase weekly benefit amounts at all. For example, maximum weekly benefit amounts have remained at \$405 in New York since 1999, \$362 in Michigan since 2002 and only \$275 in Florida dating back to 2001. During the last decade, the percentage of unemployed workers qualifying for unemployment benefits has remained largely unchanged as evidenced by Table 1.

Relatively high benefit payment levels caused by skyrocketing unemployment have impacted state solvency. In 2009, UI payments rose to

their highest level as a percentage of wages since 1975. Careful examination of insolvent states shows that these higher payment levels are not caused by overly generous UI benefit amounts but are attributable to longer UI claim durations, higher benefit exhaustion rates, and higher overall benefit costs. Those families eligible to receive unemployment benefits often find that the maximum weekly benefit amount does not keep them from falling into poverty. Weekly UI benefit amounts replace only 36 percent of prior wages on average.

A good way to judge whether benefit costs are to blame for trust fund insolvency is to examine the benefit cost rate. This key metric is the total amount of UI benefit payments as a percentage of the total wages insured by the program. Figure 4 presents the benefit cost rate as a 10-year average to smooth out spikes in benefit payouts during recessions. The general trend in UI benefit costs has been distinctly downward in the last three decades with a recent uptick in 2008 and 2009.

For the system to be in balance, the UI tax rate should hug close to the 10-year benefit cost rate. In other words, the inflows into the system must meet the outflows of benefit payouts. (In fact, the U.S. Department of Labor recently issued regulations with this as an element in a proposed new standard for qualifying for favored borrowing status¹²). The dashed line in Figure 4 demonstrates that even as outflows from benefits had dropped consistently over the last three decades, inflows fell even further. The period from the mid 1990s forward was the most serious. There were only two years — 2006 and 2007 — during which taxes exceeded the 10-year average benefit cost rate. State policy makers have been intentionally allowing the UI program fall further and further behind, and the Great Recession is making them pay for it.

In nearly all cases, today’s state solvency problems have been growing over the course of many years as a result of the active pursuit of lower UI payroll taxes or the neglect of sound UI financing principles. In the worst cases, basic UI solvency practices have either never been followed or have been ignored for decades. The federal government — by virtue of keeping the federal taxable wage base at \$7000 for the past 27 years — has not done enough to encourage states to adopt sound UI financing policies.

There is no question that state UI financing mechanisms have not produced solvency levels that reach even the modest levels recommended for forward financing of state UI trust funds. Figure 5 measures trust fund balances as a percentage of total wages, i.e., the reserve ratio. Overall, states have consistently failed to build UI trust fund reserves over the past three decades. While trust fund levels recovered following the severe recessions of the early 1980s, they recovered only modestly during the prosperous 1990s, and have fallen even lower over the last 10 years.

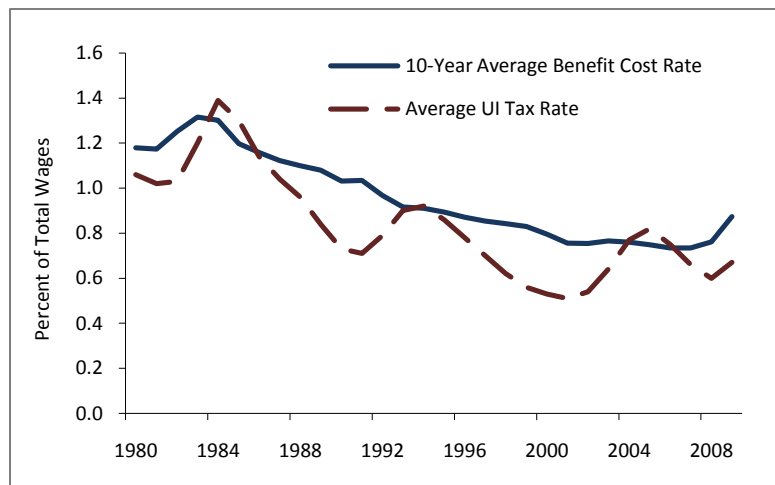


Figure 4. Unemployment Insurance Payout and Tax Rates

Entering the current recession, states had \$38.3 billion in trust fund reserves. The national reserve ratio was 0.8 and the U.S. AHCM was 0.52, both well below recommended pre-recession trust fund solvency levels. In comparison, states entered the 2001 recession with

\$54.05 billion in UI trust fund reserves, an amount that was also below accepted levels of pre-recession solvency.

B. The 1970s and 1980s

The next section traces the history that led to the inadequate financing of the UI program starting with the 1970s. The 1970s were the first period of significant state UI trust fund loans since the UI program was created in the 1930s. While the U.S. had recessions prior to 1975, the 1975-76 recession was the worst since World War II in terms of its impact on UI trust funds. Congress reacted by passing a series of benefit extensions and expansions of coverage (e.g., to include public employees and agricultural workers). At the same time, state programs faced unprecedented financing demands as unemployment rates and durations reached record levels. Twenty-five states took federal loans to finance state UI benefits during the 1970s recessions.

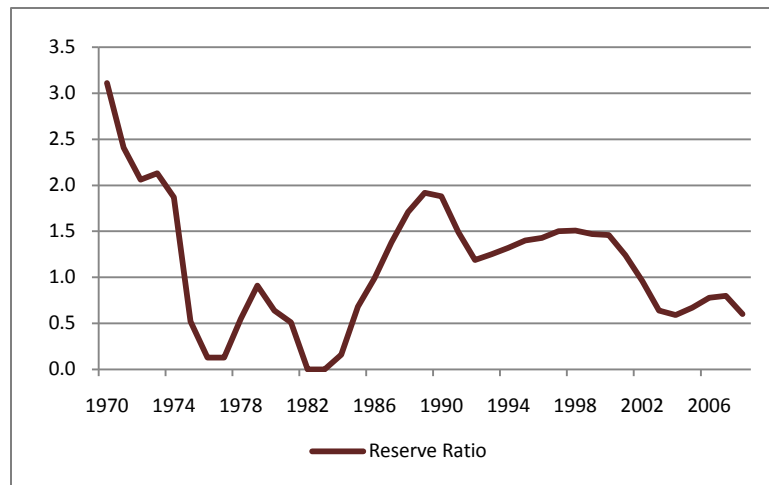


Figure 5. Unemployment Trust Fund Reserve Ratio, U.S. Average, 1970-Present

The troubles continued with the double-dip recessions of the 1980s that left nearly all states with strained finances and a significant number of states in debt. Many states, especially those in the "Rustbelt," took federal loans to pay UI benefits when state trust funds went broke. Overall, 32 state programs incurred federal loans during the early 1980s.

Eventually, these prolonged financing concerns led to both state and federal UI legislative restrictions. In response to borrowing or the risk of borrowing, many states responded to solvency pressures with measures limiting UI eligibility and increasing disqualification penalties, regardless of whether or not they actually took loans. These solvency packages were usually accompanied by state UI payroll tax increases roughly equivalent to expected benefit reductions, reflecting a so-called "equality of sacrifice" model.

Between 1981 and 1987, 44 states enacted more restrictive benefit eligibility standards or stricter disqualification provisions. During this period, 35 states increased the minimum earnings threshold to qualify for benefits and 18 states enacted stricter formulas for calculating monetary eligibility.¹³ As a consequence, the percentage of pre-layoff wages replaced by unemployment insurance declined from 36.1 percent to 34.9 percent between 1980 and 1988.

At the same time that state legislative restrictions were enacted, federal budget deficits pushed Congress to pass restrictions on extended benefits that induced state law changes in regular UI programs. Other federal UI restrictions were also passed. These restrictions were motivated by federal budget pressures when, after 1968, both state and federal UI revenues and expenditures were included in the unified federal budget.

With respect to UI financing, one important federal change was to require debtor states to pay interest on federal trust fund loans. Up to 1981, federal loans to state UI trust funds were interest free. The federal interest measures were accompanied by requirements that states demonstrate "increased solvency effort" to avoid sterner federal solvency measures.¹⁴ So, while many of the

1980s UI restrictions were imposed by state legislatures, the federal partner's actions actively encouraged trends toward more restrictive UI programs in the 1980s.

As a result of the combined impact of these state and federal legislative restrictions, the proportion of jobless workers getting UI payments declined across the board from the mid-1970s, reaching significantly lower levels by the mid-1980s. Starting from a reciprocity rate of 45 percent in 1980, UI reciprocity fell to 30 percent nationally by 1984. The legislative impact of the solvency crisis of this era has still not been entirely eliminated.

C. The 1990s and the 2000s

The country entered the decade of the 1990s in a recession. The early 1990s recession was milder than those of the mid-1970s and early 1980s, and its impact on jobless workers and UI programs was likewise less dramatic. Most states made it through the early 1990s recession without either borrowing or enacting program restrictions. Only five states (Connecticut, Maine, Massachusetts, Michigan, and Missouri) and the District of Columbia borrowed to cover state UI trust fund deficits. In response to the recession, Congress passed an Emergency Unemployment Compensation program that provided benefit extensions for three years, ending in April 1994.

The years following the early 1990s recession saw a prolonged period of U.S. economic growth. Although jobless workers were not subjected to as many restrictive measures during the 1990s as in the prior decade, states did not address UI financing responsibly. Starting in the late 1980s and spreading in the 1990s, the U.S. witnessed a wider acceptance of a UI financing philosophy called "pay-as-you-go" (others have used the term "flexible financing"). This pay-as-you-go financing approach was accepted among some business-oriented UI experts and state workforce officials. Pay-as-you-go proponents held that UI trust funds should not be forward

funded when the economy is strong, but rather UI payroll taxes should be kept low to produce greater job growth by leaving dollars in the hands of employers for investment. And, in the less likely event of a recession in a "new economy," proponents of pay-as-you-go financing acknowledged that employers would then have to pay higher UI payroll taxes.

Pay-as-you-go financing was embodied in a number of states' UI financing mechanisms starting in the late 1980s. And, in other states, pay-as-you-go served as an explanation for keeping taxes low and not maintaining state UI trust fund balances. In 1995, the federal Advisory Council on Unemployment Compensation observed that states' adoption of pay-as-you-go UI financing undercuts UI purposes relating to economic stabilization:

The extent to which an unemployment insurance system provides economic stabilization is linked to the extent to which the wage replacement function is achieved and also to the funding mechanism of the system. During recessions, a pay-as-you-go system is largely ineffective in stabilizing the economy, since it primarily redistributes money rather than pumping previously collected funds back into the economy. A forward-funding system promotes economic stabilization by increasing total buying power during recession.¹⁵

Instead of building up reserves during the extended economic recovery of the mid- to late 1990s, states began to compete with each other regarding payroll tax relief, with a majority of states enacting outright UI payroll tax cuts.¹⁶ In addition, UI payroll taxes were automatically adjusted downward as UI claims decreased in the relative economic prosperity of the late 1990s. A significant minority of states used the 1990s to adopt modest improvements in UI eligibility. By calendar year 2000, overall state UI payroll taxes had reached their then lowest le-

vels in UI program history (0.5 percent of total payrolls).

In early 2001, a recession hit the U.S. that was soon exacerbated by the economic impacts of the 9/11 terrorist attacks. UI beneficiaries rose from roughly 7 million prior to the recession to over 10 million individuals, with benefits climbing from around \$20 billion a year to over \$50 billion in both 2002 and 2003. In reaction, Congress not only passed federal benefit extensions, but also transferred over \$8 billion in "excess" federal trust funds to state trust funds.

During this period of economic distress, additional states reacted to the renewed concerns about the jobless by passing state benefit extensions and other measures expanding eligibility. Six states borrowed federal UI loans during the 2001 recession and its aftermath. Most of these states did enact modest increases to their taxable wage bases. But the fact that many other states escaped insolvency meant that few states reckoned with their weakened solvency positions. Many of these states ignored the condition of their trust funds, and left their taxable wage base at or slightly above the federal minimum of \$7000. Several state legislatures took advantage of the slight economic expansion and cut employer taxes. And with a short and lackluster economic recovery following the 2001 recession, UI solvency failed to improve between 2004 and 2008.

Georgia is a state that exemplifies some of the worst trends in state UI financing. The state cut the minimum tax rate all the way back to zero percent from 2000-2005. By the end of 2003, the tax moratorium permitted Georgia businesses to save about \$1.1 billion in unpaid unemployment taxes.¹⁷ Moreover, all of these tax reductions brought the trust fund down to a point where it met a threshold in the statute for the levying of additional taxes. The legislature consistently overrode those automatic tax increases, saving employers tens of millions more in 2005 and 2006. This pattern of legislative meddling was repeated in other states like Mas-

sachusetts and New Jersey, in each instance paving the way for state insolvency.

CONCLUSION

The financing system for unemployment benefits is under unprecedented distress, but the situation is not simply the result of the deep recession. The system failure is a result of years of poor financing policy decisions, and the current crisis should compel policy makers to forge a new path to forward financing of the unemployment insurance program.

III. THUMBNAIL EXPLANATION OF UI FINANCING AND SOLVENCY TERMINOLOGY

Information below explains the basic terminology used here in discussing UI solvency as well as providing more details about federal rules that apply to states with longer-term federal trust fund loans.

A. Understanding Three Basic Measures for UI Trust Fund Solvency

The following terms are commonly used to analyze UI trust fund solvency:

1. Reserve Ratio or Trust Fund Percentage of Total Wages. The Reserve Ratio or Trust Fund as Percentage of Total Wages is a state's trust fund balance as a percentage of that state's total wages for the past 12-month period. Trust fund reserves are compared with state wages, roughly comparing the size of the trust fund balance to the risk being insured by UI (loss of wages). Reserve ratios are useful solvency measures because they reflect the size of a state's economy. There is no accepted reserve ratio standard recommended by UI solvency experts, although a pre-recession reserve ratio of at least 2.0 is wise in our view.

Cost multiples compare the size of past UI benefit payment amounts in a 12-month period to trust fund balances. There are two cost multiple benchmarks in commonly reported data.

2. High Cost Multiple. A High Cost Multiple (HCM) of 1.0 means that a state has one year's reserves at its historically highest level of benefit payments without relying upon UI payroll tax revenues. HCMs compare trust fund balances to the highest-cost 12-month period of payments in a state's history. An HCM of 0.5 converts to six months, an HCM of 1.0 equal 12 months, and so forth. In the 1950s, an HCM of 1.5 (or 18 months) was widely accepted as a prudent level of pre-recession UI reserves.

3. Average High Cost Multiple. The Average High Cost Multiple (AHCM) was adopted in the 1990s in light of concern that HCMs were overly conservative measures of solvency, i.e., they set the solvency bar too high. A state's AHCM is the average of the three most recent high-cost calendar years that include either three recessions or at least 20 years history. The Advisory Council on Unemployment Compensation, a federal advisory panel, recommended in 1995 that states maintain a pre-recession AHCM of 1.0.

Cautionary Note: The total dollars found in a state's UI trust fund, in and of itself, tells an observer little about the trust fund's ability to carry a state through a recession.

B. Understanding Federal Borrowing Rules and Requirements

Once a state trust fund approaches insolvency, the state typically begins borrowing from the Federal Unemployment Account (FUA), which is funded with federal payroll (FUTA) taxes paid by employers. State requests for trust fund loans are made by letter to the Secretary of Labor for a three-month period and are made no earlier than the first of the month prior to the three-month request period. If states have uncommitted Reed Act funds (federal dollars which can also be used for administrative purposes) in their trust funds, those dollars must be used to pay benefits before the state can begin borrowing.

States may make voluntary repayments on the principal of the debt at any time. Generally, interest accrues on federal loans on a federal fiscal year basis with interest payments due by September 30. However, there are some exceptions to the interest requirement, the largest of which is cash flow loans. Cash flow loans occur when the state borrows and repays all outstanding loans by September 30 and then does not borrow again in the last calendar quarter of the year. *Under the American Recovery and Reinvestment Act, interest on all federal borrowing was waived through December 31, 2010.* Had this waiver not been enacted, the interest rate on federal borrowing in 2009 would have been 4.64 percent.

There are mechanisms in the Federal Unemployment Tax Act (FUTA) by which the federal government automatically recoups principal on state borrowing if the state does not do so voluntarily. Employers in states with unemployment laws that conform to federal law receive a credit against their federal unemployment taxes. (The result is that all employers pay \$56 per employee per year in FUTA taxes.) However, if a state has an outstanding loan balance on January 1 of two consecutive tax years, the FUTA credit for all employers in the state is reduced by 0.3 percentage points (unless the entire balance is paid by back by the following November 10.) This reduction in the FUTA credit translates to an increase in FUTA taxes of \$21 per employee. If the balance is not repaid in the subsequent two years, the FUTA credit reduction increases by 0.3 percentage points annually. As a result, employer taxes increase by an additional \$21 in each of the subsequent two years.

In addition to these credit reductions, there is the potential for additional credit reductions in years three to five of a state's indebtedness, if a state is not making progress toward restoring solvency. The rules around these additional tax reductions are fairly complex. The additional reduction in years three and four is based on the state's average tax rate, while the addition-

al credit reduction in the fifth year also factors in the state's five-year average benefit cost.

There are also provisions in federal laws that allow states to either avoid or put a cap on FUTA credit reductions. Generally, states can avoid a FUTA credit reduction by repaying all loans advanced in the prior year by November 10, borrowing before the following January 31, and by taking legislative measures to increase solvency. States can freeze their credit reduction at the prior year's level by taking no action to decrease tax effort or solvency, decreasing their loan balance and maintaining an average tax rate that equals or exceeds the five-year average benefit cost rate.

Finally, the U.S. Department of Labor has recently proposed regulations governing interest-

free cash flow loans, which had not previously been limited by any financial standards. While these new requirements only apply to short-term state borrowing, they provide insight into the kinds of measures that the federal government would likely consider prudent in crafting any future relief for borrowing states. To qualify for interest-free loans, states would need to have:

- An Average High Cost Multiple (AHCM) of 1.0 in one of the five years prior to the borrowing year, and
- An average tax rate that is at least 80 percent of the prior year's rate and 75 percent of the average benefit cost rate over the prior five years.

¹ *Annual Economic Report of the President*, Council of Economic Advisers, February 2010.

² The principal authors of this briefing paper are NELP staffers Rick McHugh, George Wentworth, and Andriette Roberts with assistance from Andrew Stettner and Christine Riordan. Portions of this paper are derived from earlier NELP publications on UI financing and policy. All NELP publications are available at our website <www.nelp.org>.

³ U.S. Department of Labor, Employment and Training Administration, Office of Unemployment Insurance, Division of Fiscal and Actuarial Services, *UI Outlook* (February 2010), Overview.

⁴ The 34 jurisdictions with insolvent UI trust funds were Alabama, Arizona, Arkansas, California, Colorado, Connecticut, Delaware Florida, Georgia, Idaho, Illinois, Indiana, Kansas, Kentucky, Maryland, Massachusetts, Michigan, Minnesota, Missouri, Nevada, New Hampshire, New Jersey, New York, North Carolina, Ohio, Pennsylvania, Rhode Island, South Carolina, South Dakota, Texas, Vermont, Virgin Islands, Virginia and Wisconsin.

⁵ Enrique Martinez-Garcia and Janet Koeh, "A Historical Look at the Labor Market During Recessions," Federal Reserve Bank of Dallas *Economic Letter* v. 5, No. 1 (January 2010).

⁶ Non-profit firms and government agencies do not pay experience-rated state UI taxes. Instead, they reimburse states for UI benefits paid to their employees. Non-profits and governmental entities are also not subject to federal UI taxes. These employers are usually known as "reimbursing employers," since they are billed for any benefits paid to their former employees and expected to reimburse states for those benefits.

⁷ Three states have UI taxes paid by employees; they are Alaska, New Jersey and Pennsylvania (only when the trust fund falls below a certain level).

⁸ Phillip B. Levine, "Financing Benefit Payments," in Christopher J. O'Leary and Stephen A. Wandner, ed., *Unemployment Insurance in the United States: Analysis of Policy Issues*, (Kalamazoo, Michigan, Upjohn Institute, 1997), p. 332.

⁹ National Association of State Workforce Agencies, UI Trust Fund Solvency Survey (December 2009), available at <naswa.org>.

¹⁰ For added UI financing background, see Wayne Vroman, "The Recession of 2001 and Unemployment Insurance Financing," (Urban Institute, January 2005), available on the Urban Institute website. For more in-depth information, see Wayne Vroman, *Topics in Unemployment Insurance Financing* (Kalamazoo, Michigan, Upjohn Institute, 1998) and Marc Baldwin, *Beyond Boom and Bust: Financing Unemployment Insurance in a Changing Economy* (National Employment Law Project, April 2001).

¹¹ Wayne Vroman, *Topics in Unemployment Insurance Financing*, p. 10.

¹² 20 CFR 606, *Federal-State Unemployment Compensation Program: Funding Goals for Interest Free Advances*, Federal Register, Vol. 74, No. 121, Thursday June 25, 2009, Proposed Rules.

¹³ General Accounting Office (September, 1988).

¹⁴ Marc Baldwin and Rick, McHugh, "Unprepared for Recession: The Erosion of State Unemployment Insurance Coverage Fostered by Public Policy in the 1980's", Economic Policy Institute Briefing Paper, (June 1, 1992).

¹⁵ Advisory Council on Unemployment Compensation, *Unemployment Insurance in the United States: Benefits, Financing, Coverage* (1995), p. 45.

¹⁶ *Id.*

¹⁷ *Id.*

**National Employment Law Project
Solvency Update - April 2010**

Currently insolvent 33 States and Virgin Islands		
State	Trust Fund Balance (millions)	Months of Benefits Saved In The Trust Fund
Alabama	-\$269	0
Arizona	-\$22	0
Arkansas	-\$318	0
California	-\$8,409	0
Colorado	-\$186	0
Connecticut	-\$422	0
Delaware	-\$1	0
Florida	-\$1,497	0
Georgia	-\$337	0
Idaho	-\$181	0
Illinois	-\$2,057	0
Indiana	-\$1,807	0
Kansas	-\$65	0
Kentucky	-\$760	0
Maryland	-\$104	0
Massachusetts	-\$279	0
Michigan	-\$3,783	0
Minnesota	-\$638	0
Missouri	-\$687	0
Nevada	-\$331	0
New Hampshire	-\$23	0
New Jersey	-\$1,551	0
New York	-\$3,001	0
North Carolina	-\$2,136	0
Ohio	-\$2,229	0
Pennsylvania	-\$2,814	0
Rhode Island	-\$204	0
South Carolina	-\$851	0
South Dakota	-\$23	0
Texas	-\$2,026	0
Vermont	-\$23	0
Virgin Islands	-\$13	0
Virginia	-\$317	0
Wisconsin	-\$1,338	0

Will be insolvent 1 State		
State	Trust Fund Balance (millions)	Months of Benefits Saved In The Trust Fund
Tennessee	\$95	1

Likelihood of insolvency uncertain 3 States		
State	Trust Fund Balance (millions)	Months of Benefits Saved In The Trust Fund
Hawaii	\$81	3
West Virginia	\$91	4
Iowa	\$285	5

Likely to remain solvent in 2010 13 States, DC and Puerto Rico		
State	Trust Fund Balance (millions)	Months of Benefits Saved In The Trust Fund
Nebraska	\$114	7
New Mexico	\$209	7
Oregon	\$810	8
Montana	\$115	8
Wyoming	\$117	9
Oklahoma	\$383	9
Washington	\$2,108	10
Utah	\$393	11
North Dakota	\$73	13
Puerto Rico	\$349	14
Alaska	\$254	16
Mississippi	\$414	17
Maine	\$278	17
District of Columbia	\$300	17
Louisiana	\$1,022	21