State Notes

TOPICS OF LEGISLATIVE INTEREST

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Michigan's Unemployment Compensation Fund
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Michigan's Unemployment Insurance program has been stressed by the increasingly high level of unemployment in Michigan. Michigan unemployment benefits have exceeded unemployment tax revenue each year since 2001. Beginning in 2006, the balance in the State Unemployment Compensation Fund has been reduced to a level that has required the State to use loans available from the Federal government to pay benefits pending the receipt of State unemployment tax revenue. As of December 31, 2008, the State had $772.5 million in Federal loans outstanding and is continuing to borrow in order to pay unemployment benefits.

Due to the prolonged deficit in the benefits fund, in June the State met the statutory thresholds to trigger a State solvency tax, which will be assessed beginning January 1, 2009. The State also is expected to trigger an additional Federal unemployment tax, the Federal Unemployment Tax Act (FUTA) credit reduction, beginning January 1, 2010.

This article reviews the basic operation of the unemployment insurance system, the ongoing borrowing to pay benefits, Federally funded extended benefit programs, the expected additional tax costs to employers, and the State budget impact.

Employee Benefits under the Unemployment Insurance System

Unemployment insurance provides covered employees with the short-term replacement of wages when they become unemployed through no fault of their own. When an unemployed worker applies for benefits, the Unemployment Insurance Agency (UIA) is able to verify wages and employment through data routinely reported by employers. Based on the data, an approved claimant's amount and duration of benefits are determined through a statutory formula. Benefit payment amounts vary and are determined by a formula based on quarterly wage data and the number of dependents. An approved claimant can receive up to $362 per week for as many as 26 weeks of benefits (although some claimants are eligible for as few as 14 weeks of benefits). While receiving unemployment benefits, the recipient must certify to the UIA that he or she is seeking and available for full-time employment.

The Federal law provides for extended unemployment benefits through a combination of ongoing programs triggered by specific economic conditions and special purpose acts of Congress. Michigan workers currently may qualify for Emergency Unemployment Compensation through two temporary extended benefits programs enacted at the Federal level. These programs are 100% Federally funded. Under each program, Michigan workers who have exhausted their unemployment benefits may receive additional weeks of benefits. Workers who exhaust regular unemployment benefits no later than March 28, 2009, will receive up to 20 additional weeks of benefits; the number of weeks is 80.0% of the benefit weeks originally determined. If these additional weeks are exhausted on or before March 28, 2009, a worker may qualify for up to an additional 13 weeks (50.0% of the number of weeks for which he or she initially qualified).[1]

[1] "Emergency Unemployment Compensation (EUC) in Michigan", Fact Sheet #120, November 2008, Michigan Unemployment Insurance Agency, available at http://www.michigan.gov/documents/uia/EUC_Fact_Sheet_120_240939_7.pdf]

Applications to these programs may be made until March 28, 2009, and payments attributable to the programs will continue until August 29, 2009. The UIA has estimated that these extensions will benefit about 63,000 unemployed individuals in Michigan.

Also, states are required to include in their unemployment insurance law a section pertaining to extended benefits for those claimants who have exhausted their standard benefit eligibility during times of high unemployment. This program requires states to cover 50.0% of the costs of providing extended benefits. The Federal and state threshold for eligibility for this program is based on the insured unemployment rate (IUR) instead of the total unemployment rate (TUR). The IUR includes only those individuals who are collecting benefits, not the unemployed who are no longer receiving benefits. Under the law, the IUR rate must be 5.0% or higher for the previous 13 weeks and 20.0% higher than the IUR for the same period in each of the last two years. Although Michigan's seasonally adjusted employment rate was reported at 9.6% in November 2008, the IUR (4.9% as of 12-6-08) remained below the 5.0% trigger for most of 2008, meaning the State currently is not eligible for this program.

In 2003, Michigan enacted a temporary extended benefit measure to participate in an optional Federal program in which the trigger for extended benefits is based on the TUR, requiring the rate to be at least 6.5% for the last three months and 110.0% of the TUR for the same period in either or both of the preceding two calendar years. The act included a sunset on the change at the end of 2003.

Funding for Unemployment Insurance

Unemployment Insurance programs are funded by a combination of state and Federal taxes on employers. The Federal Unemployment Tax Act requires payment of a Federal payroll tax on the first $7,000 of employee income. The standard rate for this tax is 6.2%, which is offset by a 5.4% credit if the employer has paid its state unemployment taxes and the state unemployment law and administrative practices are in conformity with Federal law. The net FUTA tax rate for most contributing employers, after the credit, is 0.8%. This revenue is deposited in the Federal Unemployment Trust Fund where it is available for the payment of the costs of administration of the state UI programs, cash-flow lending to states, known as Title XII loans, and extended benefits programs. In Michigan, Public Act (P.A.) 251 of 2008, which is the fiscal year (FY) 2008-09 appropriation act for the Department of Energy, Labor, and Economic Growth (DELEG), includes $136.5 million in Federal revenue for State administrative costs for the Unemployment Insurance program.

The State Unemployment Compensation Fund is funded by employers through State unemployment taxes. Most employers that are for-profit companies are contributing employers, meaning they pay State unemployment taxes on the first $9,000 of employee payroll for each worker at a rate determined for each employer based on the cost of employment benefits charged to that employer. The second category of employers is reimbursing employers, which do not pay unemployment taxes into the Unemployment Compensation Fund, but instead reimburse it for the actual cost of chargeable unemployment benefits paid to former employees. Governmental employers are automatically reimbursing employers and nonprofit organizations and Indian tribes may request status as reimbursing employers.

For contributing employers with at least five years of contribution and benefit history, the State unemployment tax act (SUTA) rate is made up of the following three components:

- **Nonchargeable Benefits Component.** This portion of the rate is between 0.06% (for employers with no chargeable benefits within 108 months of the computation date) and a maximum of 1.0%. Revenue from this portion of the tax is used to pay benefits that cannot be charged to a specific employer, for example, payments to employees of a company that has gone out of business or has filed for bankruptcy.

- **Account Building Component.** This rate is based on the history of all taxes paid and benefits charged to an employer's reserve account. The rate ranges from 0.0% for employers with high reserves to 3.0% for those with low reserve balances.

- **Chargeable Benefit Component.** This rate is calculated by dividing five years of benefit charges by five years of taxable payroll. Employers' rates range from 0.0% for employers with no benefit charges to 6.3% for employers with high benefit charges.

Based on these components, an experience-rated, contributing employer has a SUTA rate from 0.06% to 10.3%, with the rate determined annually for each employer.

For new employers with less than five years of experience, a separate rate schedule is established in statute. This sets the rate for new employers with no benefit history at 2.7% for regular employers and at a separately determined rate, now 7.9%, for new construction employers. The rate components described above are phased in as the employers accumulate experience in the UI system.

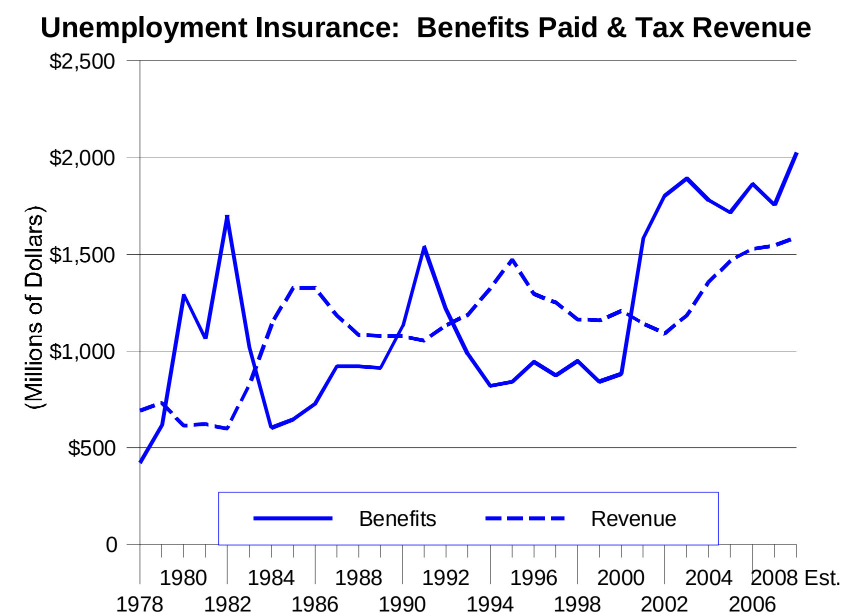
State Unemployment Compensation Fund Balance

As stated previously, the State began borrowing from the Federal government in 2006 to support benefit payments from the Unemployment Compensation Fund. Although most employers have continued to stay current in their required tax payments, an imbalance between revenue and expenditures has occurred. The Fund has a history of imbalance during poor economic times when the Unemployment Compensation Fund may be exhausted. Figure 1 shows the history of revenue and expenditures since 1978.

Currently, the State is in the eighth consecutive year during which benefit payments have been greater than revenue, the longest stretch of annual reductions in the Fund in the program's history. This prolonged economic downturn has drained the balance in the Unemployment Compensation Fund. As shown in Figure 2, the balance of the Fund was $3.0 billion in 2002. By the middle of 2008, that balance had been completely eliminated.

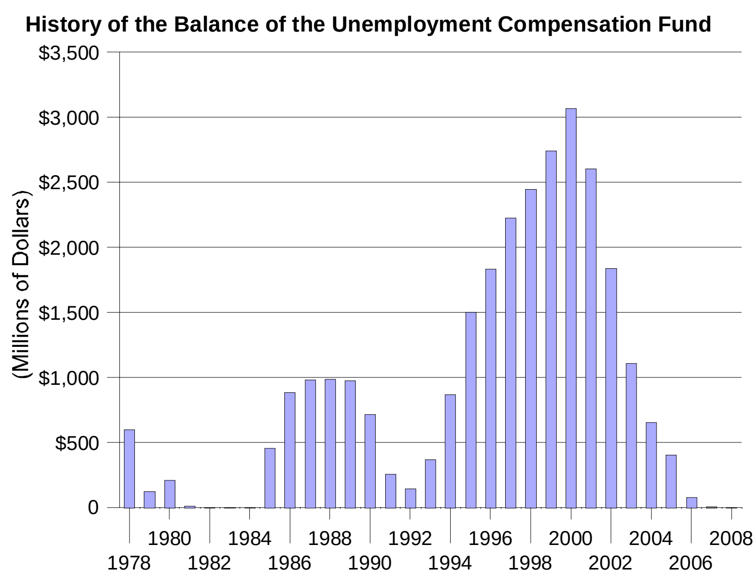
The decline in the Unemployment Compensation Fund balance is a result of a number of factors. First, Michigan's unemployment rate has continued to increase from its lowest level, 3.8% in 1999-2000, to the recent level of 9.6%. This increase in the unemployment rate over an extended period of eight years has led to an increase in the expenditures. Although revenue also has grown during this period, it has not kept pace with the increased benefit amounts. Average employer tax rates have risen as experience ratings are updated annually to reflect increased benefits paid. Due to the five-year look-back period for experience ratings, there is a lag between increased claims and the tax rate adjustment. As covered employment has declined by over 500,000 jobs since the peak in 2000, the higher average tax rates are applied to a diminished total amount of taxable wages, further constraining revenue growth.

Figure 1



Source: Department of Energy, Labor, and Economic Growth, Unemployment Insurance Agency

Figure 2



Source: Department of Energy, Labor, and Economic Growth, Unemployment Insurance Agency

Other factors contributing to the current imbalance are the policy changes made to the Michigan Employment Security Act by P.A. 192 of 2002. These changes affected both the taxes paid by employers and the benefits paid to recipients. The first of the two tax changes affected the taxable wage amount. The 2002 Act reduced the tax base from the first $9,500 of an employee's wages to the first $9,000 of an employee's wages. The second tax change lowered the minimum rate charged to an employer for the Nonchargeable Benefits Component. Before this Act was passed, the minimum rate was 0.1% for an employer with 108 months without charges to its account. The current law sets the minimum at .06%. The final major change included in this Act, that affected the balance in the Fund, was the increase in the maximum benefit payment to eligible recipients from $300 per week to $362 per week.

The UIA has estimated that combined changes from the 2002 legislation and the tax rate reduction from 1996 to 2003 (which reduced tax rates when the Trust Fund balance was greater than or equal to 1.2% of the aggregate amount of all contributing employers' payroll for each year) resulted in a cumulative loss to the Unemployment Compensation Fund of approximately $1.0 billion. The revenue declines, benefit increases, and continuing poor economic conditions have resulted in the State's using all of the $3.0 billion balance that was available at the end of 2000 and created a deficit situation in which the State, beginning in 2006, has had to borrow to meet expenditure obligations.

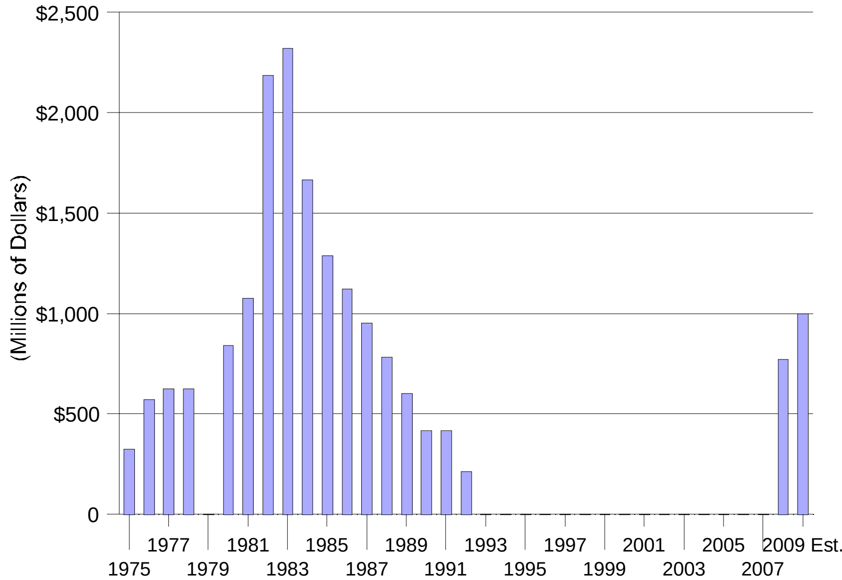
Borrowing to Pay Benefits

Federal law permits borrowing from the Federal government when the State Unemployment Compensation Fund otherwise would be unable to pay benefits. Those loans can be repaid over a period of years, if necessary, with faster repayment possible in a period of economic expansion. The amount and timing of the State's SUTA revenue and benefit payments have required the State to take advantage of these Federal loans many times. The State has borrowed from this program during recessionary periods, borrowing each year from 1975 to 1977, 1980 to 1985, and 1992 to 1993. These loans were repaid over time, sometimes over an extended period. As Figure 3 illustrates, except in 1979, the State had loan balances outstanding from 1975 to 1992.

The timing of tax receipts influences the schedule of borrowing and repayment. Contributing employers pay unemployment taxes quarterly in April, July, October, and January, with the largest collections in April. The large cash influx in April has allowed repayment of a portion of the loans, which has reduced the State's cost of borrowing. Cash flow loans obtained in 2006 and 2007 were repaid within the same year. In 2008, however, the State ended the year with a debt to the Federal government for the first time since 1992. As of December 31, 2008, the outstanding loan balance was $772.5 million, with borrowing continuing. During the first week of January 2009, the State borrowed an additional $88.3 million, increasing the loan balance to $860.8 million as of January 8, 2009. Borrowing to pay unemployment benefits is expected to decline temporarily after April 25, 2009, the next major tax collection date. The cash from those tax receipts will reduce temporarily the need for loans, but based on current and projected economic conditions, the State expects to borrow more from the Federal government in 2009 than in 2008.

Figure 3

Federal Loans Outstanding at Year End



Source: Department of Energy, Labor, and Economic Growth, Unemployment Insurance Agency

The Federal government charges interest on these loans (except for cash-flow loans issued and repaid from January to September within a calendar year). There are substantial penalties for states that fail to pay interest on time, including the elimination of all FUTA credits for employers and all Federal funds for UI administration.

These interest payments have already had an impact on the State budget. In FY 2007-08, interest payments totaling $10.8 million were made from the Contingent Fund Penalty and Interest Account. This sum consisted of $3.6 million paid in December 2007 funded through an increase in the appropriation line item for Unemployment Programs added in the conference committee for the FY 2007-08 budget, and $7.2 million paid in September 2008 funded by a legislative transfer approved on May 21, 2008, which increased the expenditure authority in the line to cover that payment. In the budget for FY 2008-09, the conference committee included the Governor's revised recommendation to add $9.4 million in General Fund/General Purpose (GF/GP) revenue to the UIA administrative lines in a fund shift that paid certain DELEG administrative costs with General Fund revenue while making Contingent Fund Penalty and Interest Account revenue available for the interest payment. The UIA is estimating that the interest costs in 2009 will total approximately $41.0 million.

The Contingent Fund Penalty and Interest Account was created in P.A. 1 of 1936. Revenue to the Fund comes from penalties and interest paid by employers that are in arrears or negligent in their unemployment taxes, and can be used for the administration of the UI Agency, including the payment of interest on Federal loans. The Contingent Fund Penalty and Interest Account also will receive revenue from the State solvency tax, which will be levied beginning January 1, 2009, and is discussed below. This solvency tax revenue will be segregated within the Fund and can be used only for interest on Federal loans. The balance in the Contingent Fund, Regular Penalty and Interest Account has been reduced in recent years and the Fund is expected to go into deficit by the close of FY 2008-09. Statutory transfers have been made out of the Contingent Fund and deposited into the General Fund to help balance the State budget. The Fund transferred $79.5 million to the General Fund in FY 2001-02. Also, P.A. 192 of 2002 restricted the balance in the Fund to $15.0 million, requiring any overage to be deposited into the Unemployment Compensation Fund beginning in FY 2001-02. Another transfer of $10.0 million from the Contingent Fund Penalty and Interest Account to the General Fund was made pursuant to P.A. 84 of 2003 in FY 2003-04.

Money in the Contingent Fund Penalty and Interest Account also has been spent for administrative costs within the Bureau of Workers' Compensation due to some previous fund shifts enacted to save General Fund dollars. In FY 2001-02, Corporation and Securities fees were used to replace GF/GP funding in the Workers' Compensation line items. Then, in FY 2006-07, Contingent Fund Penalty and Interest Account revenue was used to replace a portion of the Corporation and Securities fees in the same line items. The appropriation of $9.4 million GF/GP in FY 2008-09 eliminated all of the Contingent Fund Penalty and Interest Account revenue previously used to fund the Bureau of Workers' Compensation, which is now funded by a combination of GF/GP support, corporation fees, and securities fees.

In summary, the Contingent Fund Penalty and Interest Account has been depleted by transfers to the General Fund, use of the Fund for administrative purposes formerly supported by the General Fund, and recent interest payments. The balance in the Contingent Fund Penalty and Interest Account at the close of FY 2006-07 was $12.8 million. The balance at the close of FY 2007-08, following the interest payments, was $2.9 million. Estimates for FY 2008-09 project the Fund will have a deficit of $2.7 million at the close of the fiscal year. This reduces the options the State has for paying future interest costs.

State Solvency Tax and FUTA Credit Reduction

Due to the outstanding loan balance the State has with the Federal government, current State and Federal law requires the imposition of two additional taxes. Under State law, the State solvency tax will become effective for calendar year 2009 to raise funds to pay interest on the debt. In addition, under Federal law, the FUTA tax credit will be reduced beginning in 2010, thereby increasing the tax rate for all of Michigan's contributing employers. Revenue from this Federal tax will be used to pay the principal on the outstanding loans.

Pursuant to current law (MCL 421.19a), the Unemployment Insurance Agency will begin levying the State solvency tax on certain employers in calendar year 2009. This tax will raise additional funds to help pay the cost of borrowing from the Federal government. The tax will apply only to those contributing employers that have a negative balance in their experience accounts as of June 30, 2009; that is, employers for which benefits paid to covered employees exceeded unemployment contributions by those employers. In lieu of paying the tax, employers with a negative balance can pay the amount of that balance and avoid the solvency tax.

The UIA estimates that the solvency tax will apply to approximately 20.0% of employers. The solvency tax rate is based on the Account Building Component of each employer's unemployment tax rate. The maximum solvency tax rate is 0.75%, and the tax is applied to wages up to the $9,000 wage base per employee. The maximum amount of the tax is $67.50

per employee in 2009. The UIA has estimated that revenue from the tax will be approximately $35.0 million in 2009. By statute, the revenue is deposited into the Unemployment Insurance Contingent Fund to be used to pay the interest on Federal loans. Even with this tax revenue, there will still be an imbalance between the funds available and the projected interest liability.

The UIA projects that pursuant to Federal law, the FUTA tax rate credit currently received by Michigan employers will be reduced starting with calendar year 2010. This tax rate increase will apply to all contributing employers, with a cost of approximately $21 per covered employee. According to the UIA, revenue from the FUTA tax credit reduction is estimated at $68.0 million in 2010. The trigger for this increase is an outstanding loan balance on January 1 for two consecutive calendar years. In order to avoid this tax, Michigan would have to pay all outstanding balances by November 2009. Revenue from this tax goes directly to the Federal government and is applied to any outstanding loan balance. Depending on the level of loans outstanding, the FUTA tax credit could be reduced further in future years.

Conclusion

The insolvency in the Unemployment Compensation Fund not only will affect employers through higher tax rates, but also will affect all taxpayers, if the solvency tax revenue is insufficient to meet the interest obligations on the outstanding Federal loans. This problem has already affected the FY 2008-09 appropriation bill for the Unemployment Insurance Agency with the addition of $9.4 million GF/GP revenue to facilitate a fund shift required to make a portion of the 2009 interest payment. This is not the first time that Michigan has had to borrow to meet unemployment benefit obligations; however, this is the longest period in which net withdrawals from the Fund have persisted, causing the deficit to worsen as the economy continues to deteriorate. The economic troubles that have been plaguing Michigan have begun to affect other states as well, and Indiana and South Carolina also ended 2008 with UI loans outstanding.

Michigan may need to review the current policies that govern the unemployment benefit program. This could include consideration of statutory changes to address the imbalance between revenue and expenditures. Changes could be made to the tax base and rates charged to employers and/or the level of benefits. Other policy decisions could include determining whether changes should be permanent or temporary, and how to fund supplemental appropriations if necessary to pay interest costs on outstanding loans.

In the absence of changes to the structure of the Unemployment Insurance system, the deficit will continue until economic conditions improve. The costs of borrowing will continue to be borne primarily by employers, which will be paying the State solvency tax and a higher FUTA tax rate as the Federal tax credit is reduced.