# State Notes

TOPICS OF LEGISLATIVE INTEREST

Summer 2010

**Solvency of Unemployment Compensation Fund – An Update**
**By Elizabeth Pratt and Maria Tyszkiewicz, Fiscal Analysts**

The unprecedented 10-year economic downturn in Michigan and resulting job losses greatly increased the cost of the State's Unemployment Insurance program, which is financed by taxes on Michigan employers. Between June 2001 and June 2008, employment of people covered by unemployment insurance in Michigan declined by about 391,000. Over the next 13 months, to July 2009, covered employment fell by another approximately 450,000 jobs, more than doubling the job losses of the previous seven-year period. In 2009, benefit payments cost as much as $94.0 million per week.

These extraordinary costs exceeded the funds available in Michigan's Unemployment Compensation Fund to pay benefits, resulting in the need to borrow from the Federal government. This borrowing started in 2006, initially for cash flow loans to bridge the gap between tax collections and payments. By 2008, however, benefit payments far exceeded tax collections and Michigan began borrowing from the Federal government in order to cover the cost of unemployment benefits. In the span of two and a half years, the State has accumulated outstanding loans totaling over $3.8 billion as of August 12, 2010. While Michigan has borrowed for this purpose during past economic downturns, the current outstanding balance is greater than at any time in history, with the largest previous outstanding loan balance being $2.3 billion in 1983.

Loans from the Federal Unemployment Trust Fund are available to states for payment of benefits. They do, however, accrue interest. The American Recovery and Reinvestment Act (ARRA) of 2009 provided states a two-year forbearance on repayment and accrual of interest on these loans. This interest-free period ends December 31, 2010. In the absence of another reprieve from the Federal government or qualifying for a temporary waiver, the first interest payment of approximately $140.0 million will be due September 30, 2011. Identifying funds available to make this payment is a major budgetary challenge. The terms of the Federal loan prevent using the Unemployment Compensation Fund (the benefit account) for interest payments. Other funds, such as solvency tax revenue and contingent fund, penalty and interest account (discussed below) are insufficient to pay the obligation, resulting in a possible budget gap estimated at $91.2 million in FY 2010-11.

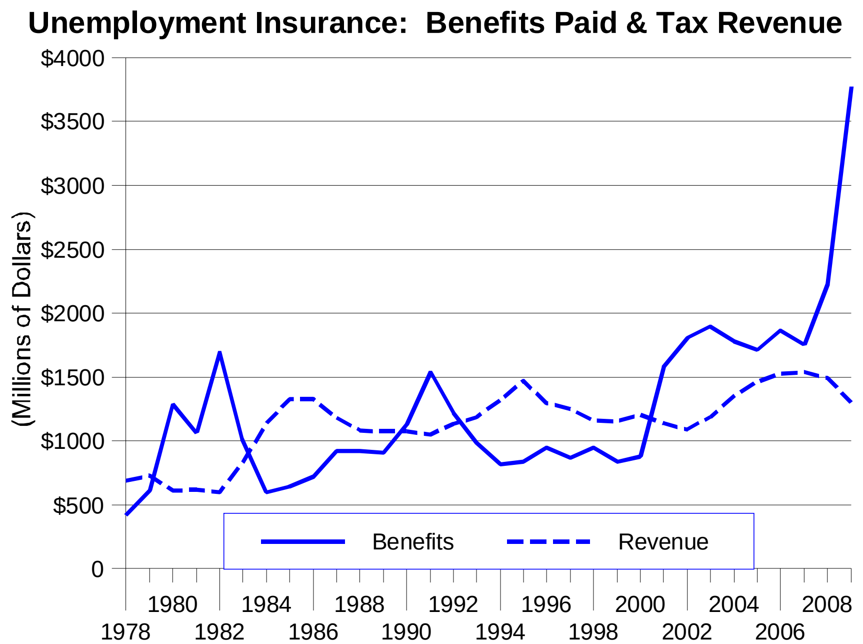
This article updates a previous paper on the solvency of the Unemployment Compensation Fund (Senate Fiscal Agency, State Notes, November/December 2008) including the history of borrowing to pay benefits, the expected additional tax costs to employers, and possible options for meeting the large interest payments that the State will incur until the Federal loans are repaid. Background on benefits including Federally funded extended benefit programs, is in Appendix 1 and a description of the State unemployment tax structure can be found in Appendix 2.

### State Unemployment Compensation Fund Balance

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.

**Figure 1**

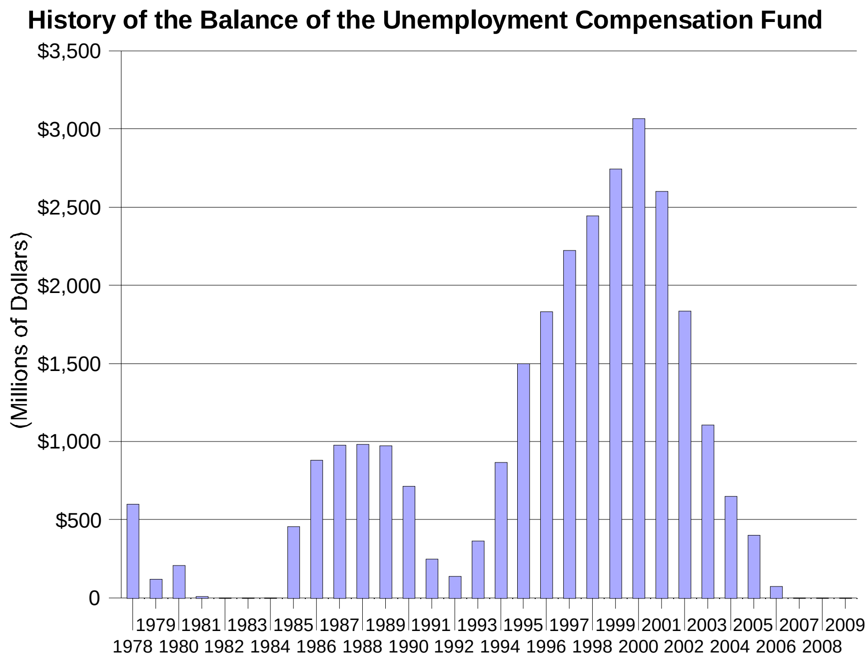



**Source:** Department of Energy, Labor, and Economic Growth, Unemployment Insurance Agency

Currently, Michigan is in the 10th consecutive year of benefit payments exceeding revenue, the longest such period 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 2000. By the middle of 2008, that balance had been completely eliminated.

A number of factors have contributed to the decline in the Unemployment Compensation Fund balance. First, Michigan's unemployment rate increased from its lowest level, 3.8% in 1999-2000, to a peak of 14.5% (as adjusted by the U.S. Bureau of Labor Statistics) in December 2009, and to the recent level of 13.2% in June 2010. This increase in the unemployment rate over an extended period of 10 years has led to an increase in unemployment compensation expenditures. Although revenue grew during most of the recent decade, tax collections declined in 2008 and 2009, increasing the gap between tax revenue and benefit payments. 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 declined, the higher average tax rates were applied to a diminished total amount of taxable wages, further constraining revenue growth. The UIA notes that for the most recent three quarters, tax collections were higher than the same quarter in the prior year and Federal loans have not increased since April 2010.

**Figure 2**




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

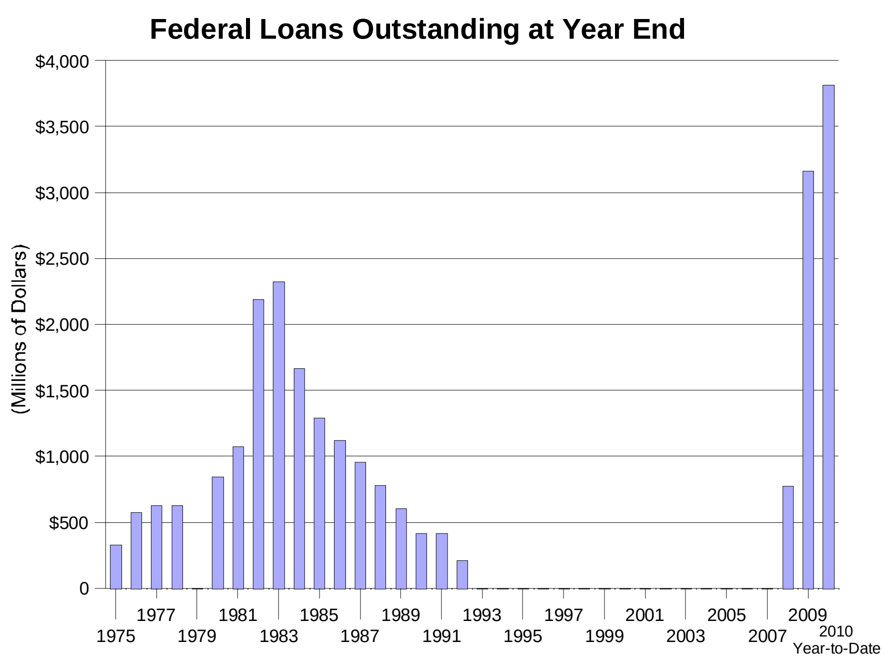
Other factors contributing to the current imbalance are the policy changes made to the Michigan Employment Security Act by Public Act (PA) 192 of 2002. These changes affected both the taxes paid by employers and the benefits paid to recipients. The first of the two tax changes affected the taxable wage amount. The 2002 Act reduced the tax base from the first $9,500 of an employee's wages to the first $9,000. The second tax change lowered the minimum rate charged to an employer for the Nonchargeable Benefits Component. Before this Act was passed, the minimum Nonchargeable Benefits Component 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 PA 192 that affected the balance in the Fund, was the increase in the maximum benefit payment to eligible recipients from $300 to $362 per week. (Appendix 1 contains background on unemployment benefits and Appendix 2 describes the State and Federal unemployment tax and credit system.)

The Unemployment Insurance Agency (UIA) has estimated that, through 2008, the 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 in excess of $1.0 billion. The revenue decline, increased benefit, 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 when tax receipts are higher and benefits are lower. The amount and timing of the State's unemployment tax revenue and benefit payments have required the State to take advantage of these Federal loans many times. The State has borrowed previously 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.

**Figure 3**




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

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. 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. By December 31, 2008, the outstanding loan balance was $772.5 million, with borrowing continuing through 2010. The cash from tax receipts reduces temporarily the need for loans, but due to the poor economic conditions and the auto industry decline in 2009, the State tripled its borrowing from the Federal government in 2009 compared with 2008.

In 2010, the State borrowed to pay benefits until the first quarterly tax collections were received. Based on forecasted economic conditions, the UIA estimates that no additional borrowing will be necessary this year. As of August 12, 2010, the outstanding loan balance was $3,814,145,991.

**Loan Repayment**

Due to the outstanding loan balance the State has with the Federal government, current Federal and State law requires the imposition of two additional taxes. These are an increase in the Federal Unemployment Tax Act (FUTA) rate in order to raise additional funds to retire the principal of the debt, and the imposition of the State Solvency Tax, pursuant to State law, to raise revenue to assist in paying the interest costs on that debt.

Pursuant to Federal law, the FUTA tax rate credit of 5.4% (described in Appendix 2) previously received by Michigan employers was reduced by 0.3%, effective for the 2009 tax year and payable beginning in 2010. This effective tax rate increase applied to all contributing employers, with a cost of approximately $21 per covered employee. The tax increase is offset, however, by a State tax reduction for positive balance employers of one-half of the extra FUTA tax paid in the prior calendar year. This credit is capped at the nonchargeable benefits component of the tax rate, which varies between 0.06% and 1.0% of taxable wages. 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 had 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. Each year the credit will be reduced by 0.3% until the entire 5.4% credit is eliminated or the loan balance is repaid. The UIA has estimated that employers will be paying the increased FUTA tax for the next 10 years, reducing the tax credit by 3.3%.

There also is the potential that additional credit reductions, on top of the 0.3% credit reduction, could be applied by the Federal government. These could be applied in year three and four and beyond if an outstanding loan still exists. These FUTA credit reductions can be limited to 0.6% of wages or the reduction from a previous year (0.3% per year) whichever is higher for states that meet certain criteria including no changes in the tax effort or solvency of the fund and a requirement that the state tax rate is at least equal to the average benefit/cost ratio computed over a five-year period. This ratio is the quotient of all unemployment benefits paid by contributing employers (including extended benefits) divided by the total wages paid by contributing employers. The loan balance also must be equal to or less than the amount prior to the third year of repayment.

In addition to repaying the principal, the Federal government requires states to pay interest on Federal Unemployment Account 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 unemployment insurance administration.

An interest payment estimated at $140.0 million will be due September 30, 2011, unless the State qualifies for a waiver or interest forebearance is extended by the Federal government.

State solvency tax revenue and the balance in the Contingent Fund, Penalty and Interest Account are expected to cover only a portion of this payment.

Under previous State law, the State solvency tax would have become effective for calendar year 2009 to raise funds to pay interest on the debt. Due to the Federal forbearance on the outstanding loans, the statute was amended in March 2009, to delay levying this tax. Pursuant to current law (MCL 421.19a), and without additional forbearance from the Federal government, the UIA will begin levying the State solvency tax on certain employers in calendar year 2011. This tax will raise additional funds to help pay for the cost of borrowing. The tax will apply only to those contributing employers that have a negative balance in their experience accounts as of June 30, 2010; that is, employers for which benefits paid to covered employees exceeded unemployment contributions by those employers will pay the solvency tax. 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 28.0% of active 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 equates to $67.50 per employee for employers with a negative balance. The UIA has estimated that the solvency tax assessments will total approximately $39.0 million in FY 2010-11. By statute, the revenue is deposited into the Unemployment Insurance Contingent Fund to be used only to pay the interest on Federal loans. Even with this tax revenue, there still will be an imbalance of approximately $101.0 million between the funds available and the projected interest liability due at the end of FY 2010-11.

Another possible source of funds to pay a portion of the interest due is the Contingent Fund Penalty and Interest Account which was created in PA 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 UIA, including the payment of interest on Federal loans. The balance in the Contingent Fund Penalty and Interest Account has been reduced in recent years. 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, beginning in FY 2001-02 PA 192 of 2002 restricted the balance of the Fund to $15.0 million, requiring any overage to be deposited into the Unemployment Compensation Fund where it was available for the payment of current benefits. Another transfer of $10.0 million from the Contingent Fund Penalty and Interest Account to the General Fund was made pursuant to PA 84 of 2003 in FY 2003-04. The $15.0 million restriction forced a transfer of $10.8 million to the Trust Fund at the close of FY 2007-08. Transfers to the Compensation Fund reduced borrowing, but if those funds had remained in the Contingent Fund, they could have been available for the impending interest payments on the outstanding loans.

Money from the Contingent Fund Penalty and Interest Account also has been spent for administrative costs within the Bureau of Workers' Compensation due to 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 used to fund the same line items. This use of the Contingent Fund Penalty and Interest Account to save GF/GP was limited when monies from this Fund became necessary to pay interest on Federal loans. 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 and $7.2 million paid in September 2008. In FY 2008-09, a fund shift added $9.4 million in General Fund/General Purpose (GF/GP) revenue to pay certain Department of Energy, Labor, and Economic Growth (DELEG) administrative costs with General Fund revenue and reduce use of the Contingent Fund Penalty and Interest Account, making that account available for possible interest payments. Because of the Federal forbearance on these payments in 2009, as discussed earlier, no interest payment has been made since 2008. 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 the 2008 interest payment. The balance in the Contingent Fund Penalty and Interest Account at the close of FY 2008-09 was $10.8 million. Estimates for FY 2009-10 include a projection that the Fund will be required to deposit $2.6 million at the close of the fiscal year to the Unemployment Trust Fund to comply with the $15.0 million cap set on the Fund. This reduces the amount the State has available to pay the future interest costs.

It is possible that the current Federal forbearance on the accrual of interest on these loans could be extended. According to the U.S. Department of Labor, there are 32 states that will be required to make interest payments in 2011. Because of the large number of states that would be affected there may be interest at the Federal level to delay or forgive these costs.

Another option available under Federal law is a nine-month grace period that would delay the first interest payment due. To qualify, Michigan must obtain approval from the US Department of Labor by demonstrating an average total unemployment rate of 13.5% or higher over the previous 12 months for which data are available. No interest would accrue on the postponed interest payment. Obtaining this waiver would push the due date for the first interest payment to June 30, 2012. Depending on economic conditions, Michigan might qualify for this waiver.

Currently the only revenue expected to be available to pay the interest cost in FY 2010-11 are the $39.0 million of solvency tax revenue and an estimated $9,804,400 available from the Contingent Fund. This leaves an unfunded gap of approximately $91.2 million that must be resolved before September 30, 2011, when the interest will first come due, absent another Federal extension or forbearance. This also could have a significant impact on subsequent State budgets. MCL 421.19a(3) states that if the solvency tax revenue is insufficient to pay the Federal interest due in any year, the UIA shall recommend that the Legislature appropriate the funds needed. The statute also states that if any such appropriations are made, these amounts are required to be repaid with interest to the State as soon as possible from solvency tax revenue. The Legislature likely will have to decide whether to attempt to appropriate GF/GP revenue to pay future interest costs, or to pursue other policy changes such as an increase in the solvency tax to fund the required interest payment or the removal of the $15.0 million cap on the balance in the Contingent Fund Penalty and Interest Account. The UIA projects that interest and principal payments will continue for 10 years. Thus, taking even a portion of the interest expenses onto the General Fund budget could have long-term consequences for the State budget.

**Conclusion**

The insolvency in the Unemployment Compensation Fund not only will affect employers through higher tax rates, but also will affect other taxpayers, as the solvency tax revenue will be insufficient to meet the estimated $140.0 million in interest due on the outstanding Federal loans for FY 2010-11, plus future obligations. It is estimated that funds available for the FY 2010-11 interest payments consist of approximately $39.0 million from the solvency tax and about $9.8 million from the Contingent Fund, Penalty and Interest Account, leaving an unfunded interest obligation of approximately $91.2 million in FY 2010-11.

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. This could include increasing the taxable wage base from the current level of $9,000, which is lower than the base level in 26 states. Michigan could join the 17 other states that index the taxable wage base to the average level of wages, a policy that reduces the likelihood of insolvency. 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.

This is not the first time that Michigan has had to borrow to meet unemployment benefit obligations, but it is the longest period in which net withdrawals from the Fund have persisted, causing the deficit to worsen as the economy has deteriorated. 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.

**Appendix 1**

**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 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 (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 is available for full-time employment. For the week of July 12, 2010, Michigan had 165,000 people collecting regular benefits.

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. During this recession, Michigan workers have qualified for Emergency Unemployment Compensation (EUC), temporary extended benefits programs enacted at the Federal level. These programs were 100% Federally funded. Under each program, Michigan workers who had exhausted their unemployment benefits were eligible to receive an additional 53 weeks of benefits. These extended benefits expire November 30, 2010. The UIA has estimated that in Michigan as of the week of June 12, 2010, Emergency Unemployment Compensation was paid to 210,000 people.

States also 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. Public Act 19 of 2009 changed the state threshold for eligibility for this program from the insured unemployment rate (IUR) to the total unemployment rate (TUR) for the period for which extended benefits were funded under ARRA. The IUR includes only those individuals who are collecting benefits, not the unemployed who are no longer receiving benefits. Under the law, if the TUR rate for the quarter is 6.5% or higher and 10.0% higher than the average rate for the same period in either of the last two years, then claimants are eligible for up to 13 weeks of benefits. However, if the TUR exceeds 8.0%, claimants are eligible for 20 weeks of benefits (80.0% of the 26 week regular benefit term). Michigan triggered on for these benefits in January 2009, first under the IUR trigger, and later through ARRA and Federal extensions, so the cost of these benefits has been borne solely by the Federal government. The final date for benefits under this program currently is November 30, 2010. When the Federal program expires, the statute requires that Michigan again go back to using the IUR as the rate for triggering these benefits. Under the statute, for these extended benefits to trigger on the IUR must be at least 5% and 120% of the average rate for the same 13-week period in each of the previous two years. The IUR as of June 26, 2010 is 4.26%, a rate that in the absence of the Federal program would be too low to trigger these benefits.

In addition to these extensions, ARRA provided an additional $25.00 to the weekly benefit. This program has expired, meaning that any new claimant filing for benefits after May 29, 2010, will not be eligible for these funds, although those individuals that are currently receiving State or Federal benefits will continue to receive this additional compensation through December 11, 2010, or until their benefits are exhausted, whichever comes first.

**Appendix 2**

**Funding for Unemployment Insurance**

Regular 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, the state's unemployment law and administrative practices are in conformity with Federal law, and the state does not have outstanding debt for payment of benefits. 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 unemployment insurance programs, cash-flow lending to states, known as Title XII loans, and extended benefits programs. In Michigan, PA 130 of 2009, which is the FY 2009-10 appropriation act for the DELEG, includes $124.3 million in Federal revenue for State administrative costs for the unemployment insurance program. In addition, ARRA provided an additional $84.4 million in 2009, which is available for expenditure through FY 2009-10.

The State Unemployment Compensation Fund is funded by employers through State unemployment taxes. 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, Indian tribes, and tribal units are reimbursing employers, however, Indian tribes and tribal units may request status as contributing employers. Nonprofit organizations 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 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 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 starting rate for new employers with no benefit history at 2.7% for regular employers and at a separately determined rate for new construction employers based on the average construction contractor rate as determined annually by the UIA. The rate components described above are phased in as the employers accumulate experience in the unemployment insurance system.