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TO AVOID LOOMING TAX INCREASES FOR EMPLOYERS AND LIKELY BENEFIT CUTS FOR UNEMPLOYED WORKERS, MORATORIUM ON STATE INTEREST PAYMENTS TO FEDERAL UI TRUST FUND NEEDS TO BE EXTENDED

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Summary

To avoid tax increases for employers and benefit cuts for unemployed workers, which would damage the still-weak economic recovery, policymakers should extend a moratorium on the interest payments that state unemployment insurance (UI) trust funds must make to the federal government for the funds they borrow to pay unemployment benefits.

States bear the full cost of paying the first 26 weeks of unemployment benefits to laid-off workers. (The federal unemployment insurance funding provided under the Recovery Act covers additional weeks of benefits for workers whose state-funded benefits run out before they find a job.) Because the economic downturn has been so long — this recession was the longest since the Great Depression — and so deep, and because a number of states did not amass adequate trust fund reserves before the recession hit, state UI trust funds have been depleted in 31 states. To continue paying unemployment benefits, these states must borrow from the federal unemployment insurance trust fund.

To date, these 31 states have borrowed a total of $39 billion. With unemployment remaining near double-digit levels and projected to remain high for a considerable period to come, the Labor Department projects that 35 to 40 states ultimately will have to borrow, with the total amount borrowed reaching $65 billion by 2013.

States are required to pay interest to the federal government on these loans and to repay the principal. While state laws vary, states typically raise the money for these interest payments by increasing taxes on employers. In many states (13 of those with insolvent UI trust funds), the law requires an automatic increase in employer taxes to cover the cost of the interest payments when the state UI trust fund has borrowed from the federal trust fund. A number of other states do not have such an automatic requirement but have in the past enacted special employer taxes to cover these costs.

States likely will implement these tax increases soon after the new year begins. Of the 31 states with insolvent trust funds, 28 start their legislative sessions in January 2011 or before.[1] In order to pay the interest by its due date of September 30, 2011, states will have to implement tax increases as soon as possible to get collections in time to pay for the interest. In the 13 states with insolvent trust funds in which tax increases occur automatically, state employment agencies may begin alerting employers and changing tax forms in the last few months of 2010.

Given the need to raise taxes on employers to pay loan interest and ultimately to repay loan principal, states may seek to lower their ongoing UI costs to mitigate the total effect on employers by cutting unemployment insurance benefits, which are not generous to begin with, and by restricting eligibility for the benefits, which already is sufficiently restrictive that fewer than half of unemployed workers receive benefits in an average month. Cutting benefits to laid-off workers and raising taxes on employers while the economy is weak only make the economy weaker and slow economic recovery.

In the past, some other states have financed the interest payments out of their general-fund budgets. This is not a sound option now either. Because the current downturn has been so long and deep and state revenues have plummeted with the decline in the economy, state budgets continue to face very large shortfalls. A state can make these interest payments out of its general budget only by raising other taxes or cutting other programs even more deeply than the state otherwise needs to do — actions that themselves further reduce demand in the economy and thereby slow recovery and job creation.

Recognizing the adverse economic effects of raising taxes on employers, cutting benefits for unemployed workers, or forcing larger increases in other taxes or deeper cuts in other programs during a pronounced economic slump, federal lawmakers enacted a moratorium on these interest payments until December 31, 2010 as part of last year's recovery legislation. The moratorium now needs to be extended.

And to ensure that states do not begin to cut UI benefits and restrict UI eligibility amidst a weak economy as a result of their looming UI interest and principal repayment obligations, an extension of the moratorium should be accompanied by a "maintenance-of-effort" provision that precludes states from cutting UI eligibility and benefits during the moratorium period.[2]

Essentially, this would be a state option — a state could opt to make use of the moratorium extension. If it did so, it would maintain its eligibility and benefit rules during the moratorium extension period.

[1] California's session is scheduled to start in November. New Jersey is already in session. Another 26 states with insolvent trust funds will begin their sessions in January.

[2] States that are participating in the Federal Additional Compensation program, which pays an extra $25 per week in benefits to all unemployment insurance recipients, may not reduce their unemployment benefit levels. The MOE does not, however, prevent states from enacting provisions that restrict eligibility for benefits. Maintenance of both benefit levels and eligibility rules is necessary to preserve unemployment insurance for workers who lose jobs in the future.

The Problem of Huge Principal Repayment Obligations

States' obligations to begin repaying the loan principal pose an even more serious problem over time. Under current law, three states will have payments due this fall, and the loans of 22 more states will come due in 2011.

This presents multiple problems. Employers in states that do not repay the full amount of their loans by these deadlines will be required to pay steadily increasing amounts of federal unemployment insurance tax each year. Alternatively, states may enact large increases in employer taxes before the economy is ready to absorb them in order to repay some or all of the loans. In either case, there are likely to be severe cutbacks in UI benefits and eligibility as states come under pressure to slash their ongoing UI costs in order to limit the increases in employer taxes. Following the recession of the early 1980s, some 44 states cut UI eligibility and/or benefits as they faced loan repayment costs. Partly as a consequence, the percentage of unemployed workers receiving unemployment benefits plunged from 50 percent in 1975 to 28 percent in 1983.[3]

Furthermore, many states facing large repayment obligations will find it almost impossible to simultaneously pay off these obligations, pay current UI benefits, *and* build large trust fund reserves before the next recession hits. The likely result will be that states enter the next recession with even more inadequate reserves than the reserves with which they entered the current downturn. The UI system could reach a breaking point.

To avoid these serious problems, the federal government will likely need to provide some repayment relief. Such relief should be provided, however, only as a *quid pro quo*. In return for some *partial* repayment relief, states should be required to institute UI financing reforms to meet standards that reduce their need to borrow so heavily from the federal government in future recessions. In essence, the federal government would provide some repayment relief in the next few years in return for states instituting financing reforms that reduce the federal government's exposure as a lender in future recessions. Such arrangements also should include benefit protections to assure that states do not hollow out their UI programs as part of this process.

The actions recommended here are needed to prevent these UI interest payment and loan repayment obligations from hitting at the wrong time and damaging the economic recovery. In congressional testimony, Mark Zandi, chief economist of Moody's Analytics, recommended that Congress extend the interest payment moratorium and give states more time before having to start making loan repayments. "Without such relief," Zandi noted, "states will be forced to raise payroll taxes at just the wrong time for the economy."[4] Zandi noted that these additional employer taxes would hit at a time when the economy is still weak and unemployment insurance taxes on many employers already are rising in many states because of "experience rating" provisions in state laws.

[3] Testimony of Andrew Stettner, National Employment Law Project, at U.S. House of Representatives, Ways and Means Committee, Subcommittee on Income Security & Family Support, May 6, 2010.

[4] Testimony before the Senate Finance Committee, April 14, 2010.

Trust Fund Borrowing

The unemployment insurance trust funds of 31 states have been depleted. These states are able to continue paying the regular 26 weeks of unemployment benefits to their unemployed residents only because they are able to borrow from the Federal Unemployment Trust Fund Account (FUTA). As of August 19, these 31 states have borrowed a total of $39 billion from the federal government, with the total continuing to rise. The Labor Department projects that 35 to 40 states ultimately will have to borrow, with total loans outstanding reaching $65 billion by 2013. (These loans help to support the first 26 weeks of unemployment benefits, which are entirely state funded.)

States have had no alternative but to borrow these funds, because their own state UI trust funds have been exhausted. While about half of the states entered this recession with balances of less-than-optimal size in their UI trust funds, it also is the case that this recession has been unusually long and unemployment continues to be high. In its most recent projections, the Congressional Budget Office estimated that an average of 9.0 percent of the workforce would remain unemployed in 2011.

Federal law generally requires that these loans be paid back in full, plus interest. Ordinarily, interest charges on loans taken in federal fiscal year 2009 would already be due. In enacting the American Recovery and Reinvestment Act last year, however, policymakers recognized that forcing states to begin paying the interest now, when state budgets are severely depleted by the recession, would impede economic recovery. Fostering economic recovery requires boosting state spending, not reducing it further, as numerous economists and others have pointed out in recent months.

The Recovery Act includes a moratorium through December 31, 2010 on state interest payments on these loans. (Interest payments that would have been due during that period are forgiven.) But unemployment is much higher and is lasting much longer than was expected when the Recovery Act was enacted. If the moratorium expires as scheduled at the end of the year, states will have to pay approximately $1.4 billion in interest during federal fiscal year 2011, rising to $2.2 billion in fiscal year 2012, according to Labor Department estimates.

States are not permitted to make these interest payments from their normal UI taxes on employers. Under the UI laws of approximately 21 states (13 of which currently have insolvent trust funds), an additional tax is levied on employers when interest payments must be made on funds the state has borrowed from the federal UI trust fund. Other states have a history of enacting temporary levies on employers to finance these interest costs. Most states likely will implement these tax increases soon after the new year begins, as 28 of the 31 states with insolvent trust funds will begin their legislative sessions in January 2011 or before, and states likely will want to limit the magnitude of the employer tax increase needed to pay the interest charges by their due date in September 2011. As Mark Zandi noted, these additional employer taxes would hit at a time when the economy is still weak, and at a time when unemployment insurance taxes on employers already are going up in many states because of automatic provisions in state UI laws.[5] States that do not levy an additional tax on employers may pay the interest out of their general funds, but since states' general-

[5] Taxes on individual employers may be rising because of "experience rating," the provisions of UI that raise taxes on employers based on their history of laying off employees. Taxes on all employers are rising in some states because of changes states have made to help pay benefits, which include increases in UI tax rates or increases in the amount of wages subject to taxation. In some states, tax increases are triggered automatically when trust fund balances are low.

fund budgets must be balanced even in economic downturns, this can require cutting other programs or raising other taxes to cover the interest costs while the economy is still down, thereby placing a further drag on economic growth.

State Fiscal Problems – A Drag on the Economy

An extension of the interest moratorium is necessary because state finances are expected to remain weak next year – and beyond. The unemployment rate, which has a large impact on state revenues, is expected to decline only modestly next year. States have closed deficits in their operating budgets for state fiscal year 2011, which ends on June 30, 2011 in most states, of more than $100 billion, even after taking the fiscal relief provisions of the Recovery Act and Congress' recent extension of additional fiscal relief into account. State deficits for fiscal year 2012 are expected to be close to $140 billion (with little Recovery Act funds remaining). The budget cuts and tax increases that states will have to impose to close these shortfalls will significantly reduce demand in the economy and create a drag that slows economic recovery.

Before Congress' August extension of additional fiscal relief for states, Goldman Sachs projected that economic growth would slow later this year in part because "state and local budget cutbacks will almost certainly still be weighing on overall demand."[6] Similarly, Mark Zandi warned that large state budget cuts next fiscal year "will be a serious drag on the economy at just the wrong time."[7] This potential for fiscal drag is still a problem, since even after using the new federal funds states will be struggling to close sizeable deficits, as the shortfalls figures in the previous paragraph indicate.

Although the large state budget deficits that will compel these budget cuts and tax increases are in state general funds (i.e., state operating budgets), which are distinct from state UI trust funds, there is a strong connection from an economic standpoint. As part of their efforts to balance their general fund budgets during this recession, 20 states have raised taxes on businesses. With massive state shortfalls continuing to loom, legislation to raise business taxes remains under consideration in a number of states. These revenue-raising measures can help states lessen the severity of cuts in basic services and of layoffs of teachers, public safety personnel, and the like. But the presence of these other business tax increases makes it more difficult for states simultaneously to place UI tax increases on employers and vice versa.

The "Maintenance-of-Effort" Provision

The last time the trust funds of so many states became insolvent was during the back-to-back recessions of the early 1980s, when 32 state programs were forced to borrow from the federal trust fund. Following those recessions, as states worked to pay interest, repay the loans, and restore trust fund solvency, they made changes in their programs that undermined the availability of UI for many unemployed workers and reduced the adequacy of benefits. Between 1981 and 1987, 35 states increased the minimum earnings threshold to qualify for benefits and 18 states enacted more

[6] *GS US Economics Analyst,* January 29, 2010.

[7] Zandi, Mark, "What's Wrong with the Job Market, and How to Fix It," Moody's Economy.com, November 25, 2009, p. 7.

unfavorable formulas for calculating benefits.[8] States also cut their UI eligibility criteria or benefit levels in a variety of other ways.

As states struggle to make interest payments in 2011 and 2012 and principal payments on their FUTA loans also come due, states will have strong incentives to once again curtail eligibility and benefits in order to cut costs and thereby reduce the degree to which taxes on employers have to be raised. In addition, some states could be tempted to roll back recent, long-overdue improvements in their UI programs.

Following the sharp contraction in UI benefits in the 1980s, Congress established a blue-ribbon bipartisan commission to study the unemployment insurance program. The commission, which was chaired by Janet Norwood, a highly regarded former Bureau of Labor Statistics' commissioner who had served under Democratic and Republican presidents alike, recommended a number of changes in UI. Congress acted on none of them — until the Recovery Act.

The Recovery Act contains financial incentives for states to adopt several UI modernization reforms that the Norwood commission had recommended. These reforms are of particular importance to low-wage workers, part-time workers, and women who lose their jobs — and enable more of these workers to qualify for UI benefits. In recent decades, the percentage of unemployed low-income, female, and part-time workers who have been able to obtain UI benefits has been very low.

As a result of these Recovery Act provisions, about four in every five states now have adopted some of these reforms and are receiving federal incentive payments for doing so. But while state legislation adopting these reforms must establish them as ongoing (rather than temporary) features of a state's UI program for the state qualify for the federal incentive payments, there is no bar to a state subsequently repealing the reforms.

For these reasons, we recommend including a maintenance-of-effort requirement that a state would have to abide by as a condition of its benefiting from an extension of the moratorium on interest payments. In other words, the moratorium on interest payments would be a state option: States that elect to use it would maintain both their UI eligibility levels and benefit computation methods during the moratorium period.

Principal Repayment

Repayments of the principal on outstanding FUTA loans start to become due this fall from Michigan, Indiana, and South Carolina. Some 22 additional states will have principal repayments due in the fall of 2011, with others coming due in 2012. The principal repayments will place a much greater strain on states (and on employers and beneficiaries) than the interest payments discussed above as they are much larger.

There likely will be a need for partial forgiveness of the loans or alternative arrangements for repaying them. Under federal law, the federal unemployment tax on employers in a state rises

[8] National Employment Law Project, *Understanding the Unemployment Trust Fund Crisis of 2010*, April 2010.

automatically if a state does not make principal repayments on schedule. Moreover, the potential for such automatic increases in employers' FUTA taxes — coupled with the need to make interest payments and the changes states will have to make to UI taxes to restore solvency — will intensify employer pressures on states to cut UI benefits and restrict eligibility to shrink UI costs. In addition, some principal payment relief is likely to be needed if states are to be able to rebuild their trust funds to adequate levels before another economic downturn occurs. The size of the outstanding loan balances in some states suggests it would be extremely difficult for these states to raise taxes on employers sufficiently to simultaneously repay their loans and rebuild their trust funds — and greatly increases the likelihood of substantial cuts in UI eligibility and benefits.

Any federal relief from loan repayments, however, should be tied to reforms of state trust fund financing. States should be required to institute reforms that would ensure their state UI trust funds are built to, and maintained at, more adequate levels in the future so that fewer and smaller loans from the federal trust fund are needed when subsequent recessions hit. Trust funds should be forward-funded so that sufficient amounts are accumulated during times when the economy is strong.[9] Partial relief from loan repayments also will need to be tied to benefit and eligibility standards.[10]

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[9] For issues relating to the need to reform state financing, see Government Accountability Office, Unemployment Insurance Trust Funds: Long-standing State Financing Policies Have Increased Risk of Insolvency, GAO-10-440, April 2010; and Testimony of Andrew Stettner, National Employment Law Project, before the House Ways and Means Committee, Subcommittee on Income Security and Family Support, May 6, 2010.

[10] Relieving the burden on states that have borrowed funds from the federal unemployment trust funds will raise some equity issues. Some states have raised UI taxes on employers to maintain solvency and have thereby avoided borrowing; these tax increases are as much a drag on economic recovery right now — when the job market is still weak — as would be the interest payments that the borrowing states would have to make. It may thus make sense to provide some assistance to states that have not borrowed, perhaps by giving them added interest on their trust fund balances held by the federal government or through another mechanism. Some equity arrangement also may need to be developed with respect to any principal forgiveness.