

**Testimony of
Andrew Stettner
National Employment Law Project**

**Hearing Before the
U.S. House of Representatives,
Ways & Means Committee,
Subcommittee on Income Security & Family Support**

May 4, 2010

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May 6, 2010

Chairman McDermott and members of the Committee: Thank you for this opportunity to testify on the trust fund insolvency crisis facing the state and federal unemployment insurance program and the impact of this crisis on the viability and effectiveness of the unemployment safety net.

My name is Andrew Stettner, and I am the Deputy Director of the National Employment Law Project (NELP), a non-profit research and advocacy organization that specializes in economic security programs, including unemployment insurance (UI), Trade Adjustment Assistance (TAA) and the workforce development system. NELP has a long history of serving families hit hard by economic downturns by helping them access benefits and services under these economic security programs and promoting innovative state and federal policies to strengthen them.

Chairman McDermott, thank you for your critical leadership, especially since the recession began, in helping to steer the nation's unemployment insurance program through the toughest economic disaster this country has faced since the Great Depression. As a result of your efforts and those of your colleagues, federal unemployment insurance extensions and UI provisions in the American Recovery and Reinvestment Act of 2009 (the Recovery Act) have provided strong relief to the nation's unemployed families while reducing job loss and boosting the nation's economy. With today's hearing, the Committee is initiating a timely discussion of the UI program's financing crisis, a critical first step toward responsible reform of the program.

Today, we would like to emphasize the following points describing the roots of the solvency crisis and the path towards responsible financing of the unemployment insurance system.

- Forty states are likely to face unemployment insurance trust fund deficits of \$90 billion (cumulative) by FY 2013. Already numerous states have contemplated making sharp benefit cuts in a counterproductive response to this funding crisis, and pressure will grow for more states to do so if Congress does not protect the program.
- The UI funding crisis is deeply rooted in years of short-sighted state unemployment insurance financing decisions, including record low unemployment insurance taxes during good economic times that failed to build up the reserves necessary to pay benefits during even a mild recession. Indeed, those states that took responsible steps to finance their programs by indexing their taxable wages were four times less likely to borrow from the federal treasury to pay state unemployment benefits.
- States entered this recession less prepared than in any recession in recent history; even a much milder recession would have wiped out all of the limited trust fund balances in

many states. The unsustainable revenue system now only charges premiums on slightly more than a quarter of wages, and federal rules only require states to collect premiums on the first \$7,000 of each employee's annual earnings.

- To reduce the pressure on states to cut workers' benefits and enact steep tax increases, Congress should continue the waiver of federal interest on trust fund loans through 2011. This continued relief should be tied to an explicit maintenance of effort requirement that ensures the UI program will continue to deliver support jobless workers and their families need, especially now at a time of such high unemployment.
- If states' programs are not repaired in the wake of this severe recession, workers will not be able to count on them the next time the economy dips into recession. Perhaps more than at any point in the 75-year history of the program, the federal partner will need to take effective action to help the states restore the unemployment insurance program to the core principle of "forward funding," while protecting the benefits side of the program.

The ultimate test of the solution to the solvency crisis should be whether it steers the UI program onto a course of responsible financing, enabling it to reliably and effectively deliver benefits to jobless families and stabilize and stimulate a struggling economy.

1. Unemployment Insurance Has Sustained Millions of American Families Through the Worst Job Market Since the Second World War

It is impossible to overstate the positive impact the UI program has had on the economy over the two-plus years since the recession began in December 2007. During this time, the program has delivered a total of \$141 billion in state unemployment benefits to an economy starving for economic demand. And the federal extensions, full funding of Extended Benefits, and Federal Additional Compensation (FAC) have contributed more than \$90 billion to the economy. Economists have consistently pointed to the potent multiplier effect of UI benefits, as cash circulates from the hands of jobless workers into local economies. According to Mark Zandi of Moody's Economy.com, "[t]he part of the stimulus providing the biggest bang for the buck—the most economic activity per federal dollar spent—is the extension of unemployment insurance benefits."¹

More than 17 million Americans per year have relied on the jobless safety net during the recession.² The benefits these workers received have prevented families from falling from the middle class into poverty. CBO's previous research found that poverty rates among longer term UI recipients would have been as high as 50 percent had it not been for UI. A more recent analysis found that federal unemployment benefit programs from the Recovery Act alone were estimated to have kept 800,000 Americans out of poverty in 2009 and the effect is sure to grow through 2010. And the experience of the past two years has proved years of research right – that UI benefits keep families in their homes, able to support themselves and maintain their dignity.

With the unemployment rate projected to remain over eight (8) percent through the end of 2012, the unemployment safety net will continue to play a key role in creating a sustainable recovery and holding together the fabric of our communities. This reality puts in sharp relief the urgency of protecting and sustaining the jobless safety net even in the face of the serious financing problems the committee will be discussing today.

2. Unemployment Trust Fund Financing Has Reached a Crisis Point

By almost every measure, the financing problems facing the unemployment program have reached a crisis point. As of April 28, 2010, 34 states and the Virgin Islands had drained their UI trust funds and been forced to borrow over \$41 billion from the federal government in order to continue paying state UI benefits. Twelve states, including many of the nation's largest states, have already borrowed more than \$1 billion dollars (California, Michigan, New York, Pennsylvania, Ohio, North Carolina, Illinois, Texas, Indiana, New Jersey, Florida and Wisconsin).

Borrowing from the federal government will rise as weak labor markets persist in coming years, and payroll contributions to the trust funds continue to fall short of the amounts being paid in state benefits. The U.S. Department of Labor (US DOL) predicts that in FY 2011, state UI collections will increase to \$52 billion in revenue (from \$31.4 billion in FY 2009), but that state benefits will still be at the elevated level of \$75.1 billion.³ By the end of FY 2013, as many as 40 of the 53 UI jurisdictions will have borrowed over \$90 billion altogether in federal loans for state trust funds.⁴ As a result, the Federal Unemployment Account (FUA), which funds loans to states, has itself become insolvent and is borrowing from the federal treasury to cover the state loans.

3. Financing Problems Pressure State UI Programs to Reduce Benefits

The Committee is holding this hearing at a crucial juncture in the emerging debate about unemployment insurance financing. The outcome has serious implications for the program's ability to protect the economy and working families.

- The unemployment safety net is at risk because of irresponsible funding of the program.

The nascent economic recovery would be gravely imperiled by a repeat of the 1980s' solvency crisis that produced major cuts to the UI program. During that period, 32 states took out federal loans. Between 1981 and 1987, 44 states enacted more restrictive benefit eligibility standards or stricter disqualification provisions. More specifically, 35 states increased the minimum earnings threshold to qualify for benefits and 18 states enacted stricter formulas for calculating monetary eligibility.⁵ In large part due to these major cuts in benefits, the percent of jobless workers receiving UI benefits plummeted from 50% in 1975 to 28% in 1983. And the U.S. has been living with low rates of workers collecting unemployment benefits ever since those cuts.

The Recovery Act helped lessen the pressure on states to reduce benefits, by waiving the interest on UI trust fund loans until December 31, 2010. The current interest rate, which fluctuates along with the rate for treasuries, is now 4.34%. Despite the breathing room

provided by the Recovery Act, trust fund insolvency has begun to provoke serious state discussion of benefit cuts:

- New Jersey: After pledging in a radio interview to leave the UI system untouched, Governor Christie proposed reducing the maximum weekly unemployment benefit by \$50, instituting a waiting week, and imposing higher penalties for workers who are fired from their jobs and apply for UI.⁶
- Rhode Island: Governor Carcieri proposed a package that included \$7 million in tax increases and \$48 million in benefit cuts in response to the state's trust fund solvency crisis.⁷ The benefit cuts included a 10% reduction in the maximum weekly benefit amount and a 10% cut in the benefit calculation formula – proposals that were projected to knock \$80 per week off of the state's average weekly unemployment insurance benefit.
- Vermont: Governor Douglas proposed to institute a waiting week and to slice the benefit amounts of the majority of claimants by adopting a more restrictive benefit eligibility formula.⁸ The final negotiation seems set to include the institution of the waiting week, and a freeze in the state's maximum weekly unemployment benefit which is normally adjusted each year.⁹
- Kentucky: The Kentucky House of Representatives passed H.B. 349, which instituted a waiting week for benefits and reduced the weekly UI benefit amount by 10 percent. The proposal did not get through the Senate but the benefit cut issue will return again next year.

Thus far, states have largely stopped short of making the counterproductive decision to reduce benefits in the midst of the severe labor market, but as they face increased federal penalties and other pressures to pay back their loans, we anticipate many states will take up more extreme proposals to cut benefits. If a few states were to begin cutting benefits, the pressure on other states to follow suit and appear more "business-friendly" could quickly build into a downward spiral.

The pressure to restrict benefits comes on the heels of historic progress to modernize the eligibility rules of the program, made possible by the \$7 billion in funding provided by the Recovery Act to modernize state UI programs. Thanks to the Recovery Act, in just a little over a year, 31 states have already taken action to make their UI programs more accessible to low-wage, women and part-time workers. The trust fund solvency crisis threatens to undermine these historic reforms.

4. Forward Financing of the Unemployment Insurance Program is Recognized as Crucial to Fulfilling the Program's Goals

An accurate understanding of the roots of today's UI financing crisis is critical to determining how to fix it. If today's solvency crisis is simply the result of an impossibly bad recession beyond the control of states, then perhaps no-strings-attached relief for the states would be

appropriate. However, if unsound decisions by the states set the stage for this crisis, it is incumbent on the federal partner to take a more affirmative approach that guides states toward more responsible financing in the future. As described below, the genesis of today's crisis makes the latter course the appropriate one.

The breathtaking magnitude of today's solvency crisis can be traced to the decision of states to move away from the economically sound theory of forward financing of their UI programs. Wayne Vroman, the nation's leading authority on UI financing, summarizes the overall economic theory underlying 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.¹⁰

To have a forward-financed system, a state must build up large and adequate trust fund balances before the start of a recession. The most appropriate 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. The most commonly used current measure is the Average High Cost Multiple (AHCM), which measures this ratio for the preceding three recessions. The resulting multiple is calculated in such a way that an AHCM of 1.0 means the fund has one year of reserves at historic high payout levels.

The leading experts who have studied unemployment insurance have recognized the importance of forward funding and have specifically recommended that trust funds at least equal the 1.0 level. In 1995, the Congressionally-appointed bi-partisan Advisory Commission on Unemployment Compensation concluded that:

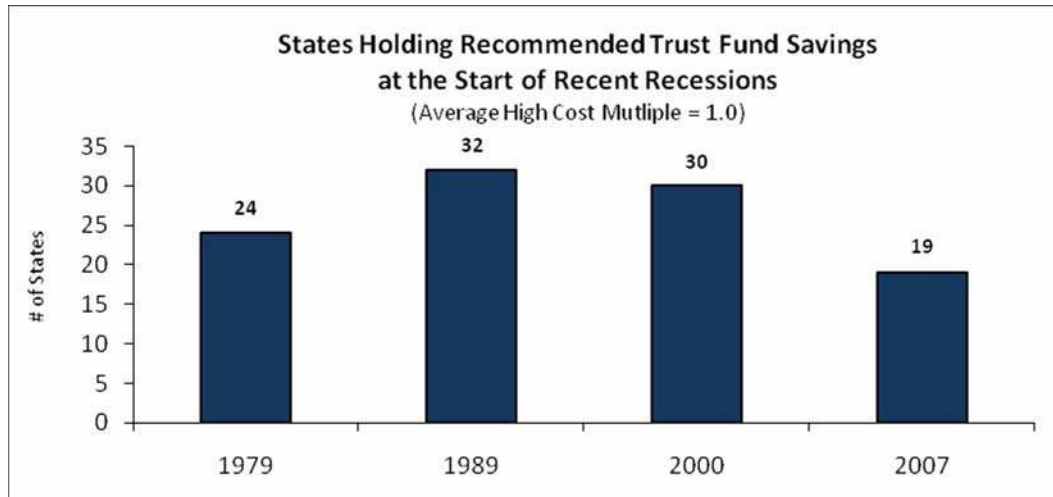
Congress should establish an explicit goal to promote the forward funding of the Unemployment Insurance system. In particular, during periods of economic health, each state should be encouraged to accumulate reserves sufficient to pay at least one year of Unemployment Insurance benefits at levels comparable to its previous high cost.¹¹

According to the U.S. Department of Labor, if the states had followed these federal solvency standards, only six states would now be borrowing from the federal government to pay state unemployment benefits. If all the states had gone into the recession with an average high cost multiple of 1.0, only 12 states would have had to borrow \$6 billion by March 31, 2010.¹²

5. States Ignored Years of Recommendations and Were Woefully Unprepared for Even a Mild Recession

Measured against the objective standards described above, states entered this recession far less prepared than they had entered any of recent recessions over the past 35 years. There was an especially steep decline in trust fund preparedness at the onset of the current downturn at the end of 2007 (just 19 states met the standard) compared to the onset of the last recession at the end of 2000 (30 states met the 1.0 standard).

Figure 1



To appreciate the lack of preparedness for even a mild downturn, we have simulated the impact of a recession similar to the downturn in the early 1990s, when the national unemployment rate peaked at 7.8%. Table 1 below simulates where state UI trust funds would have been had benefits been paid out at the same rate as they were in the 1990s and states had brought in revenues similar to the first two years of this recession. Under this scenario, states trust funds would have stood at -\$7.5 billion, with a large number of states in debt. This compares with an end of 2009 trust fund balance of -\$15.5 billion.

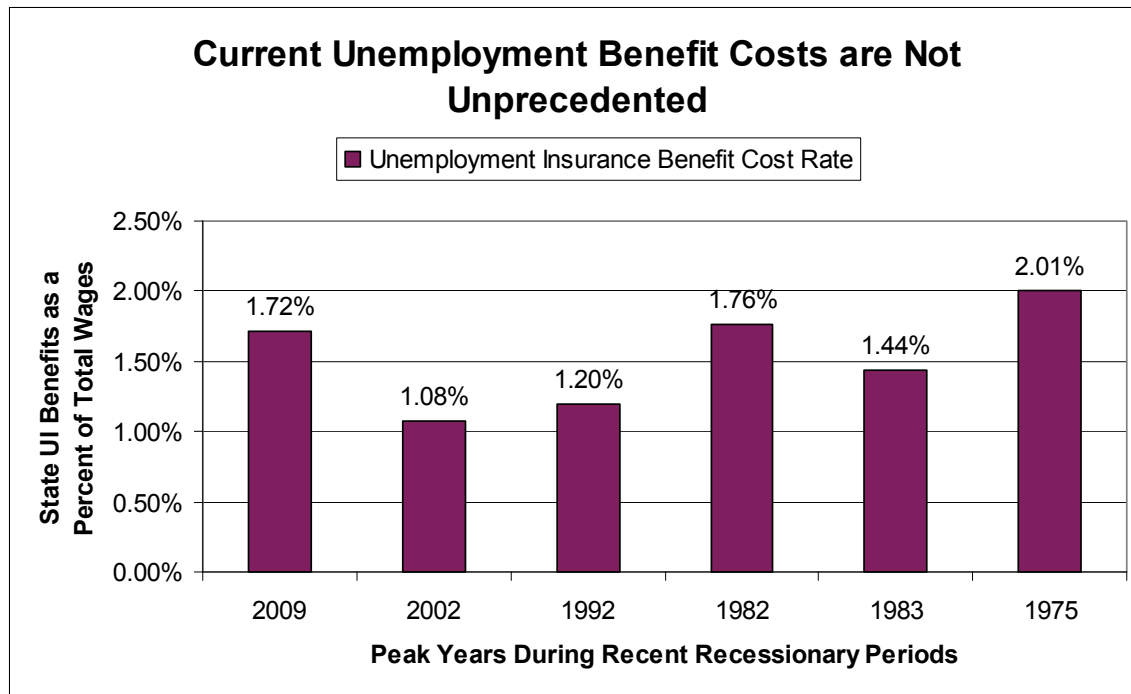
Table 1: Simulation of the impact of a modest recession on state UI Trust Funds from 2008-9

	Start of Year Trust Fund Balance	Benefits Paid	Revenues	End of the Year Balance
2008	\$38.3	\$57.9	\$31.8	\$12.2
2009	\$12.2	\$51.0	\$31.3	-\$7.5

Some observers of UI financing may argue that it was impossible to anticipate a recession of the magnitude of the current downturn, but from the standpoint of responsible UI financing, states should have been prepared for benefit payouts of this magnitude. Given the history of post-war recessions, the benefit levels that states saw in 2008 and 2009 were within the reasonable scenarios that states should have looked at when setting their UI trust fund financing policies. The basis of the above mentioned Average High Cost Multiple is the benefit cost rate – the amount of state UI benefits paid out as a percent of total wages insured by the program and

subject to premiums. The benefit cost rate was 0.85% in 2008 and approximately 1.7% in 2009—and in the context of a severe recession, not far off from previous peaks of 2.0% in 1975 and equal to the peak level of 1.7% in 1982.

Figure 2

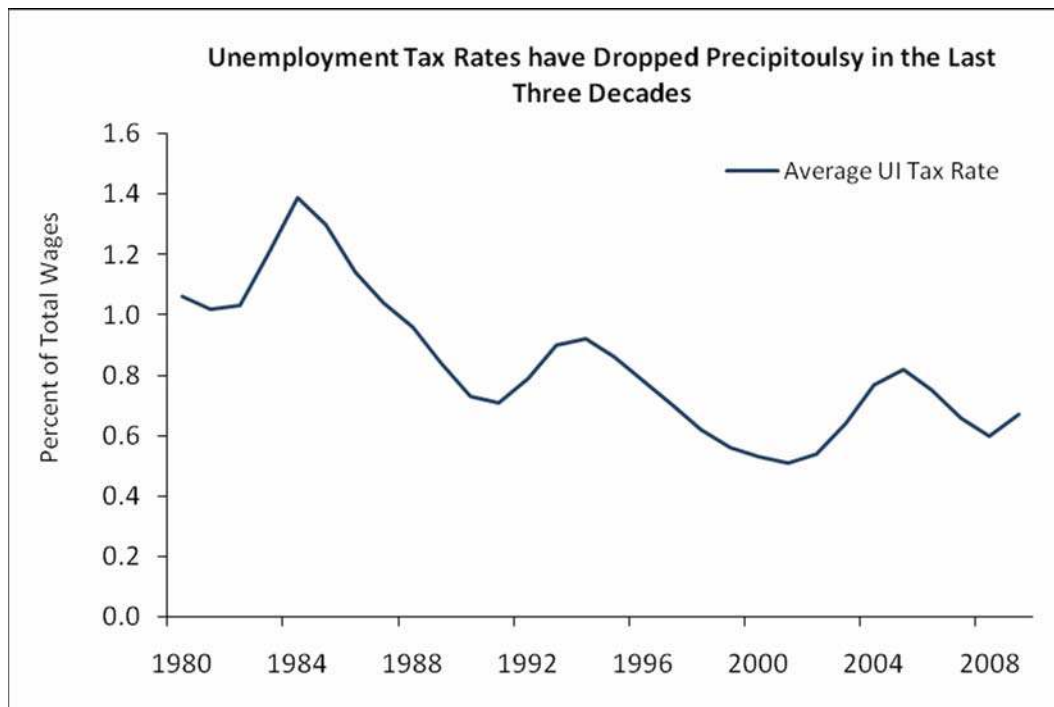


6. The Weakness of State Trust Funds was Primarily Due to Record Low Employer Taxes, Not Overly Generous Benefits

- The untold story of inadequate unemployment insurance financing

Over the last three decades, states have dramatically reduced unemployment insurance taxes relative to wages. This is the single most important reason why so many state trust funds are insolvent today. Over this period, contribution rates peaked at 1.5% of wages in 1983 and plummeted to 0.5% of wages by 2001 before climbing up just above 0.7% in 2009. Steep declines occurred as a result of 1990s-era tax cuts, with taxes dropping from over 0.9% of wages in 1994 to the low point of 0.5% in 2001. The rate going into the 2001 recession was the lowest since the data were first collected in 1938. Before the last recession began in December 2007, the rate was under 0.7%.

Figure 3



While these average tax rates are low, what is more surprising are the minimum rates of unemployment insurance taxation. This is the premium paid by stable employers to make sure that their workforce has some protection should their business unexpectedly decline. Even in 2009, 20 states allow some of their employers to pay less than \$20 per employee **per year** in unemployment insurance taxes. This minimum level of taxation does not match the vital role unemployment insurance benefits are intended to play in the economy.

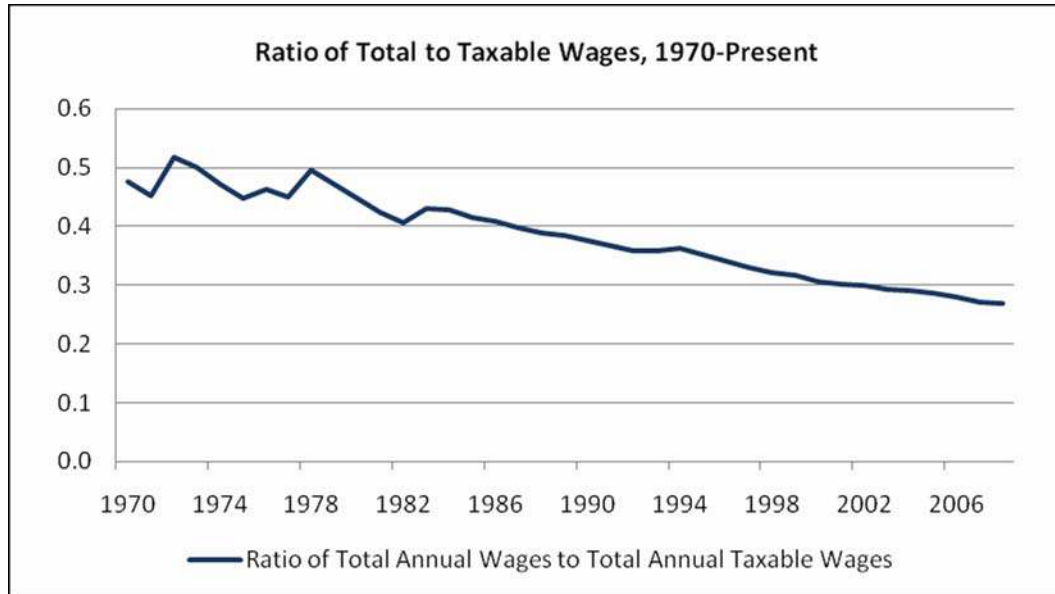
7. A Death by a Thousand Cuts: UI Trust Fund Solvency Caused by Erosion of the Base of Taxation and Active Decisions to Undermine UI Tax Rates

- The share of wages subject to UI taxes has rapidly declined in recent decades

To those outside the every-day workings of the UI system, it may come as a surprise that taxes are only due on a small portion of each worker's annual earnings. The portion subject to assessment is known as the "taxable wage base." After workers' earnings exceed this amount in a year, employers do not have to contribute any more premiums for that year.

In 1935, federal law required that both social security and unemployment insurance taxes were to be assessed on the first \$3,000 of each worker's pay check. Today, over seven decades later, that minimum figure stands at \$7,000 for unemployment insurance and \$106,800 for social security. The proportion of wages subject to UI taxes has dropped from 98% in 1938 at the start of the program to 50% in 1973 to an all time low of just over 25% now.

Figure 4



- This erosion of the taxable wage base has a major effect on the program’s solvency, and threatens its future viability.

Most states leave their nominal unemployment insurance rate structure unchanged year after year, even if wages go up significantly. With the base of wages subject to tax frozen at such low levels, states cannot recover the cost of benefits paid at today’s rates. While benefits have not become more generous, the nominal costs of benefits paid per individuals rises each year along with growth in the wages insured. States with a low fixed taxable wage are like an insurance company that is setting its rates as if it is insuring a fleet of 1982 Ford Escorts, not a fleet of the 2010 Ford Fusion. An insurance company like that would simply go out of business, and unemployment insurance is reaching a similar crisis point. Economist Phillip Levine described the problem eloquently nearly a decade ago:

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."¹³

Indeed the average taxable wage base of insolvent states is \$9,500 while the wage base of solvent states stands at \$20,500.

- Change in philosophy moved the program away from forward financing and set the stage for today’s crisis

The erosion of taxable wages can be seen partly as an issue of benign neglect. However, trust funds were also driven downward as a result of a change in philosophy of unemployment insurance financing. Starting in the late 1980s and continuing into 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”). Pay-as-you-go proponents held that UI trust funds should not be forward funded during economic good times, but rather UI payroll taxes should be kept low on the theory that doing so would allow for more employer investment to produce greater job growth. In the unlikely event of recessions (which were assumed to be milder in a ‘new economy’), taxes would be raised commensurately to quickly recover an increase in benefits cost, after which taxes and trust funds would again revert to low levels.

The Advisory Commission on Unemployment Compensation recognized that the logic of pay-as-you-go financing flies in the face of sound UI financing principles:

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 recessions.¹⁴

This recession has pointed out the folly of pay-as-you go systems that are premised on increasing businesses’ taxes immediately after a year of high claims. No state will be able to recover 2008-2010 benefits in a single year or over a few years. Understandably, states with these untenable rules are likely to take action to make sure taxes don’t increase by such a large amount in a single year.

- Unemployment benefits’ generosity is not a contributor to trust fund insolvency

While some argue the UI program has been driven towards insolvency by overly generous benefits, the evidence indicates this is not the case. 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 insolvent states have failed to increase weekly benefit amounts at all. For example, New York’s weekly maximum benefit has been \$405 since 1999; Michigan has paid only \$362 since 2002; and Florida has paid just \$275 since 2001. During the last decade, the percentage of unemployed workers collecting state unemployment benefits has remained largely unchanged, averaging just 39 percent. In 2009, average weekly UI benefits were equivalent to only 36 percent of the average weekly wage earned by workers. Though UI benefits serve as an important buffer against economic hardship for many, for some families eligible to receive unemployment benefits, the maximum weekly benefit amount is inadequate to keep them from falling into poverty.

8. States Will Struggle Mightily to Navigate Out of Trust Fund Indebtedness and Regain Trust Fund Solvency

State UI taxes are rising through experience rating (i.e., the more layoffs, the higher the tax rate) and changes in tax rates that automatically occur when funds become insolvent. A survey of state agencies revealed that 28 states had increased taxes and ten states were already at

their highest tax schedule allowed by law in 2009 due to these features of the UI system that are designed to replace the revenue needed to pay benefits during hard economic times. Most of these were as a result of automatic adjustments in taxes that went along with solvency. U.S. DOL will not publish official estimated data on UI tax levels in 2010 until later in the year, but its preliminary projections indicate that taxes will rise from just above 0.7% of total wages in 2009 to just below 1.0% in 2010, still less than the average rates experienced through the first 50 years of the program.¹⁵

While these revenues are expected to grow through 2013 through automatic increases, they won't bring the program back to solvency given the expected level of benefit payouts and the sheer size of the debts.

Beyond these automatic increases, a small number of insolvent states – generally states with smaller federal debt – have taken incremental steps to improve their financing. Meanwhile, a few other states have taken modest steps to either prevent or delay insolvency. Arkansas, New Hampshire, Tennessee, Vermont, and West Virginia have all marginally increased their taxable wage bases in 2009 or 2010. Currently, Massachusetts is considering a Governor's proposal to substantially increase and index its taxable wage base. A small number of borrowing states are still considering either an increase in the taxable wage base or an adjustment to solvency tax rates in their current legislative sessions.

However, the vast majority of states – including all of the dozen states that have borrowed \$1 billion or more – have made no major structural changes to improve the financing of their systems. Two of those states – Florida and Indiana – have actually cut employer taxes during the 2010 legislative session. Without the threat of an immediate demand for repayment of principal or accrual of interest, the largest borrowing states are generally taking a wait-and-see approach to the mounting debt liability that will fall to their states' employers.

The actuarial math of what it would take for these states to pay back their debt and establish a reasonable fund over the next economic cycle is staggering. But, even states that take the issue seriously are sharply hemmed in by "a race to the bottom" among the states that elevates lower business taxes as a key indicator of the state's economic competitiveness. Under this scenario, states will limp towards a zero trust fund level towards the end of the decade—by which time another recession is likely to come at a time of near zero reserves. This scenario makes a compelling case for a much stronger role by the federal partner in providing relief to the states, but more importantly, in setting a minimum floor for state UI contributions and other incentives to promote solvency.

9. Exceptional States Point a Way Out of the Current Trust Fund Crisis and the Key Options for Federal Reform

- States with higher and indexed taxable wage bases have largely escaped insolvency

Sixteen states have recognized that a fixed taxable wage base is no way to run an insurance program that is seeking to protect working families whose wages and expenses are rising each year. These states *index* their taxable wage base, meaning that it goes up marginally each year

to a certain percentage of the state's average annual wage. For example, Oklahoma's taxable wage base of \$14,900 is 50 percent of its average annual wage and Oregon's taxable wage base of \$32,100 is 80 percent of its average annual wage.

The difference in performance of indexed and non-indexed states could not be sharper during this recession. As of April 2010, only six of the 35 states (17%) that use fixed taxable wage bases remained solvent. In contrast, 11 of the 16 the states (69%) of the states with an indexed taxable wage base have managed to stay in the black more than two years after the recession hit. While an indexed taxable wage base does not guarantee solvency, **this single change has made states four times more likely to remain solvent than without it.** Table 2 at the end of this testimony lists the taxable wage base and solvency status of each state.

10. The Agenda for Federal Reform to Restore Forward Funding of the Unemployment Insurance Program

- A higher federal wage base could have largely ameliorated today's trust fund financing crisis

The federal taxable wage base was last increased in 1983 to its current level of \$7,000. If the wage base had kept pace with inflation since 1983, it would now be over \$15,000. If it had kept pace with inflation since the \$3,000 tax rate was first established in 1938, it would now be over \$46,000. Even a modest increase in the taxable wage base would have a major impact on trust fund solvency, as 34 states have a taxable wage base lower than \$15,000.

At NELP's request, the Urban Institute simulated what the impact of the increase in taxable wage from \$7,000 to \$14,000 on state trust fund revenues would have been leading up to the recession. This change would have increased the proportion of wages subject to UI taxation from 27 percent to 38 percent. After carefully looking at the increase in taxable wages in each state depending on its own taxable wage base, the Urban Institute found that with a \$14,000 ceiling, state tax collections in 2008 would have increased from by \$14 billion in that single year to \$44 billion.¹⁶ Just three years of this extra \$14 billion in revenue would have wiped out the current trust fund loans.

- Federal trust funds were in a better position than the states but could have been even stronger had the federal taxable wage base been adjusted

Significantly, the federal trust funds have taken major steps to help boost the state finances. In the last decade, two Reed Act distributions distributed as much as \$15 billion to the states from the federal reserves.¹⁷ The build-up of funds enabled the federal government to provide a solid program of extended benefits during and after the 2001 recession and to provide for initial months of the extension of jobless benefits during this recession.

The federal funds, too, have been impacted by the frozen taxable wage base. Only 19.5 percent of wages in 2008 were subject to federal unemployment taxes. If the base were \$14,000 per year (in fact, less than what it would have been had it been raised each year along with inflation), more than one-third of wages would have been covered. At current tax rates, this

would have generated more than \$6 billion in federal revenues.¹⁸ Several years of these revenues would have reduced the amount of borrowing from the U.S. treasury that the federal trust funds have had to undertake to pay out the loans that they are making.

- As a preliminary step, Congress should continue the waiver of interest on trust fund loans but tie it to a strong maintenance of effort provision.

Under normal circumstances, loans are interest-free only between January 1st and September 30th in the same year that the loan is provided. The Recovery Act has eliminated any interest payment until September 30, 2011. At that time, the President's budget estimates that interest payments are expected to amount to \$1.9 billion in FY 2011.¹⁹ If the 2010 interest rate of 4.36% had been applied to today's trust fund loan balances, these interest payments would be as high as \$400 million in California, \$180 million in Michigan and \$150 million in New York.

These pending interest payments will increase pressure on the states to open up the issue of UI financing at the legislative level. On a theoretical level, these interest payments like the unemployment trust fund itself are squarely the responsibility of employers. Federal rules do not allow states to pay their interest from their regular state UI tax collections, which can only be used for the payment of benefits or the repayment of the principal of federal loans that were used to pay benefits. Thus, states will have to enact piggy-back taxes on their UI tax in early 2011 to make sure funds are available by September—and if they failed to do so, the responsibility would fall to the anemic general revenues of the states. Even though 21 states already have special tax assessments in their laws to pay off the interest, the fact that states have to enact or activate a new tax gives the interest payment more weight in state policy debates than the amounts at stake imply.

The Recovery Act has played a crucial role in shielding the unemployment program from state proposals to cut benefits in the midst of the devastating job market. As a condition of participating in the Federal Additional Compensation (FAC) program, which pays an extra \$25 per week in benefits to all unemployment insurance receipts, all the states have agreed not to reduce their weekly unemployment benefits. This critical provision has gone a long way to prevent additional cuts in state UI benefits.

Taken together, the interest waiver and FAC's non-reduction rule have bought states and the millions of workers who now count on the jobless benefits program crucial breathing room in the face of massively insolvent unemployment insurance program. The interest waiver has limited the need to rush into counterproductive solvency legislation, and the FAC rule has protected the integrity of the benefits.

There have been calls to continue the waiver of interest on federal loans to the states for another year or two years.²⁰ States are grappling with numerous hard decisions about how to balance their budgets and are eager to escape pressure to reduce benefits or increase taxes in a still weakened economy. Moreover, waiving interest will continue to serve as an effective antidote to unwise proposals to reduce benefits as a part of immediate solvency legislation.

As a preliminary step to help address the solvency crisis, NELP supports a one-year continuation of the interest waiver provision of the Recovery Act, provided that the states taking advantage of the federal assistance also maintain their unemployment benefits. Thus, NELP strongly urges that Congress attach a maintenance of effort requirement to a continued waiver of federal interest in 2011. As state policymakers consider how to escape from under the weight of trust fund loans, many will demand so-called “equality of sacrifice,” with benefit reductions that match or exceed any increase in taxes. With unemployment expected to remain at levels of 8 percent or greater, communities and the economy simply cannot afford for the safety net to be cut irreparably, as it was in the 1980s.

However, as important as the FAC maintenance of effort provision is, it is limited in scope. The provision only prevents states from changing the calculation of the *amount* of unemployment benefits, but not the *eligibility* rules that determine who receives benefits. With states hungry for cost reductions, protections of both aspects of the integrity of the unemployment insurance benefit rules are needed. To protect the short-term and long-term integrity of the program, it is necessary to maintain both the amount of the benefits and access to the program. Without such a rule, the modernization improvements ushered in by the Recovery Act could easily prove to be short-lived.

- Federal unemployment taxes are expected to automatically increase in half the states by the end of 2011

Federal rules provide that if a state has a loan balance on January 1st during two consecutive years and cannot repay its balance by November 1st of that year, employers in the state face an increase in federal unemployment taxes. This is known as the FUTA (Federal Unemployment Tax Act) tax credit reduction, which increases the effective federal UI tax of employers in such insolvent states by \$21 per employee per year (\$21 per employee in year 1, \$42 per employee in year 2, etc.) These extra revenues are used to pay back principal on the loan. Already, Michigan has experienced this penalty, and as of November 1, 2010, employers in Indiana and South Carolina will incur the same penalty and have to contribute extra federal taxes by January 31, 2011. As shown in Table 2, as many as 22 states could face these reductions as of the end of 2011, with the extra federal tax payment due on January 31, 2012. These extra FUTA payments are applied directly to a state’s loan principal.

With hiring still terribly anemic even in the wake of three consecutive quarters of economic growth, policy makers are legitimately concerned about increasing the payroll tax burden on employers. The idea of postponing FUTA credit reductions presents Congress with a different set of considerations than the interest waiver. As explained in the rest of the testimony, existing state financing systems will not be able to repay the current trust fund debts without extreme state tax increases. Current administration projections show the debt being relieved only by the end of FY 2017. Under current law, automatic increases in federal unemployment taxes are a crucial part of even this delayed principal repayment—and are the only tool not subject to the cross pressures of the state legislative process. Thus, FUTA credit reductions are directly tied to the main topic of today’s hearing – the flaws in state unemployment insurance financing. And, the issue of FUTA credit reductions or any proposal for relief of the loan principals should logically be tied to the larger question of how to fix unemployment insurance financing.

- Congress has other options to encourage forward financing

An increase in the federal taxable wage base is certainly the most straightforward way for Congress to influence more responsible financing of the UI program.

But Congress has other options as well. As a preliminary matter, current federal law provides little in the way of incentives for states to build up trust fund reserves. Thus, long-term solvency plans should include positive incentives for states to build up trust fund reserves. An example recommended by the Advisory Commission on Unemployment Compensation in 1995 was to pay an extra interest premium to states that meet federal solvency standards. These rewards would go a long way toward alleviating the frustration employers in responsible states feel towards provisions like interest forgiveness for those states that have not maintained responsible financing rules.

New rules recently proposed by US DOL also point to other possible standards that could be used beyond the narrow scope of existing rules (the right to borrow interest-free between January and September).²¹ These proposals make a helpful distinction for more favorable aid to states that had in fact been solvent before the recession began and were dwarfed by a recession that exceeded anything in the state's experience. They also provide hints for more prospective standards. The proposed rule also includes a maintenance of tax effort requirement that, among other things, requires states to get assistance only if their tax rate was at least 75 percent of the rate of benefit payouts in the previous five years. As Congress considers further aid to the states, these proposed rules provide a guideline for the kind of UI financing goals that states could be prodded or required to meet.

Finally, Congress should recognize that the level of state taxation required to pull the UI trust funds into the black and rebuild trust fund solvency will be staggering in many states. With this in mind, NELP believes Congress should consider the issue of partial loan forgiveness in return for strong steps towards forward funding and strong worker benefits. This approach may be the only way to ensure that funds are available in state accounts to pay benefits for the next recession. This type of forgiveness would give Congress tremendous leverage to require state policy changes that would install forward financing provisions as a more permanent feature of UI programs and maintain strong UI benefits for families impacted by future economic downturns.

Conclusion

The crisis of unemployment insurance financing has the potential for immediate and lasting impacts on the type of income support families facing involuntary unemployment can count on and the kind of ballast the economy will receive during downturns. We commend the committee for addressing an issue so central to the future of the jobless safety net.

Table 2 – Key Solvency Indicators April 30, 2010

State	Solvency status	Date of borrowing	Federal taxes will increase, if state trust fund is insolvent on Nov. 10 of year... ²²	State taxable wage base	Indexed wage base
Alabama	Insolvent	Sep 2009	2011	\$8,000	No
Alaska	Solvent	---	---	\$34,100	Yes
Arizona	Insolvent	Mar 2010	2012	\$7,000	No
Arkansas	Insolvent	Mar 2009	2011	\$12,000	No
California	Insolvent	Jan 2009	2011	\$7,000	No
Colorado	Insolvent	Jan 2010	2012	\$10,000	No
Connecticut	Insolvent	Oct 2009	2011	\$15,000	No
Delaware	Insolvent	Mar 2010	2012	\$10,500	No
District of Columbia	Solvent	---	---	\$9,000	No
Florida	Insolvent	Aug 2009	2011	\$7,000	No
Georgia	Insolvent	Dec 2009	2011	\$8,500	No
Hawaii	Solvent	---	---	\$38,800	Yes
Idaho	Insolvent	Jun 2009	2011	\$33,300	Yes
Illinois	Insolvent	Jul 2009	2011	\$12,520	No
Indiana	Insolvent	Nov 2008	2010	\$9,500	No
Iowa	Solvent	---	---	\$24,500	Yes
Kansas	Insolvent	Feb 2010	2012	\$8,000	No
Kentucky	Insolvent	Jan 2009	2011	\$8,000	No
Louisiana	Solvent	---	---	\$7,700	No
Maine	Solvent	---	---	\$12,000	No
Maryland	Insolvent	Feb 2010	2012	\$8,500	No
Massachusetts	Insolvent	Feb 2010	2012	\$14,000	No
Michigan ²³	Insolvent	Sep 2006	2009	\$9,000	No
Minnesota	Insolvent	Sep 2009	2011	\$27,000	Yes
Mississippi	Solvent	---	---	\$7,000	No
Missouri	Insolvent	Feb 2009	2011	\$13,000	No
Montana	Solvent	---	---	\$26,000	Yes
Nebraska	Solvent	---	---	\$9,000	No
Nevada	Insolvent	Oct 2009	2011	\$27,000	Yes
New Hampshire	Insolvent	Mar 2010	2012	\$10,000	No
New Jersey	Insolvent	Mar 2009	2011	\$29,700	Yes
New Mexico	Solvent	---	---	\$20,800	Yes
New York	Insolvent	Jan 2009	2011	\$8,500	No
North Carolina	Insolvent	Feb 2009	2011	\$19,700	Yes
North Dakota	Solvent	---	---	\$24,700	Yes
Ohio	Insolvent	Jan 2009	2011	\$9,000	No
Oklahoma	Solvent	---	---	\$14,900	Yes
Oregon	Solvent	---	---	\$32,100	Yes
Pennsylvania	Insolvent	Mar 2009	2011	\$8,000	No
Rhode Island	Insolvent	Mar 2009	2011	\$19,000	No
South Carolina	Insolvent	Dec 2008	2010	\$7,000	No
South Dakota	Insolvent	Oct 2009	2011	\$10,000	No
Tennessee	Insolvent	Apr 2010	2012	\$9,000	No
Texas	Insolvent	Jul 2009	2011	\$9,000	No
Utah	Solvent	---	---	\$28,300	Yes
Vermont	Insolvent	Feb 2010	2012	\$10,000	No
Virginia	Insolvent	Oct 2009	2011	\$8,000	No
Washington	Solvent	---	---	\$36,800	Yes
West Virginia	Solvent	---	---	\$12,000	No
Wisconsin	Insolvent	Feb 2009	2011	\$12,000	No
Wyoming	Solvent	---	---	\$22,800	Yes

Source: U.S. Department of Labor.

Table 3 – Potential Interest Payments on Current Trust Fund Loans

	Balance as of April 28, 2010	Federal Interest Payment Based on Current Balance (Payment Due September. 30, 2011)
Alabama	\$283,001,164	\$13,131,254
Arizona	\$40,886,351	\$1,897,127
Arkansas	\$330,853,383	\$15,351,597
California	\$8,859,078,902	\$411,061,261
Colorado	\$253,697,150	\$11,771,548
Connecticut	\$498,452,705	\$23,128,206
Delaware	\$12,901,505	\$598,630
Florida	\$1,612,500,000	\$74,820,000
Georgia	\$416,000,000	\$19,302,400
Idaho	\$202,401,700	\$9,391,439
Illinois	\$2,239,582,343	\$103,916,621
Indiana	\$1,856,438,938	\$86,138,767
Kansas	\$88,159,421	\$4,090,597
Kentucky	\$795,100,000	\$36,892,640
Maryland	\$133,840,765	\$6,210,211
Massachusetts	\$387,313,005	\$17,971,323
Michigan	\$3,876,782,333	\$179,882,700
Minnesota	\$711,246,296	\$33,001,828
Missouri	\$722,116,933	\$33,506,226
Nevada	\$395,394,607	\$18,346,310
New Hampshire	\$24,321,180	\$1,128,503
New Jersey	\$1,749,563,533	\$81,179,748
New York	\$3,176,873,428	\$147,406,927
North Carolina	\$2,292,762,317	\$106,384,172
Ohio	\$2,314,186,799	\$107,378,267
Pennsylvania	\$3,008,614,961	\$139,599,734
Rhode Island	\$222,480,710	\$10,323,105
South Carolina	\$884,957,170	\$41,062,013
South Dakota	\$24,027,178	\$1,114,861
Tennessee	\$20,736,767	\$962,186
Texas	\$2,077,252,958	\$96,384,537
Vermont	\$32,657,065	\$1,515,288
Virgin Islands	\$13,321,650	\$618,125
Virginia	\$346,876,000	\$16,095,046
Wisconsin	\$1,424,768,541	\$66,109,260
Total	\$41,329,147,760	\$1,803,851,983

Endnotes

¹ Mark Zandi, Testimony before the Joint Economic Committee, October 29, 2009, p. 3.

² UI state first payments peaked at 14.5 million per year in October 2009. As of April 2009, 2.3 million were receiving federal extended benefits, and given the lags between these programs none of them could have been the same individuals.

³ *UI Outlook, Overview*. U.S. Department of Labor, Employment and Training Administration, Office of Unemployment Insurance, Division of Fiscal and Actuarial Services (February 2010), available at http://www.ows.doleta.gov/unemploy/content/prez_budget.asp.

⁴ Ibid.

⁵ U.S. General Accounting Office, *Unemployment Insurance: Trust Fund Reserves Inadequate* (GAO HRD-88-55: September 1988), p. 74.

⁶ Gov. Chris Christie is expected to propose changes to N.J. unemployment system, *Newark Star Ledger*, February 24, 2010.

⁷ "Proposal To Restore Unemployment Insurance Trust Fund Solvency," Rhode Island Department of Labor And Training, presented to the Employment Security Advisory Council on March 24, 2010.

⁸ "Vermont Budget Cuts Would Undermine Jobless Safety Net," National Employment Law Project, April 26, 2010

⁹ Vermont officials reach deal on jobless fund, *Burlington Free Press*, May 4, 2010.

¹⁰ Wayne Vroman, *Topics in Unemployment Insurance Financing* (W. E. Upjohn Institute for Employment Research: 1998), p. 10.

¹¹ Advisory Commission on Unemployment Compensation, Benefits, Financing and Coverage, February 1995.

¹² Statement Of Jane Oates, Assistant Secretary For Employment And Training, U.S. Department Of Labor before The Committee On Finance, United States Senate, April 14, 2010.

¹³ 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*, (W. E. Upjohn Institute for Employment Research: 1997), p. 332.

¹⁴ Advisory Council on Unemployment Compensation, *Unemployment Insurance in the United States: Benefits, Financing, Coverage* (1995), p. 45 (citations omitted).

¹⁵ Unemployment Insurance: State Trust Fund Insolvency, Presentation by the U.S. Department of Labor to the National Employment Law Project Conference - Washington DC, December 7, 2009.

¹⁶ Unpublished Urban Institute calculations.

¹⁷ This includes the \$8 billion Reed Act distribution in 2002, and the \$7 billion made available through incentives under the Recovery Act, of which \$2.84 billion have already been distributed. States are eligible but have not applied for an estimated \$1.3 billion of these funds for a total of \$4.1 billion.

¹⁸ Ibid.

¹⁹ U.S. Department of Labor, UI Outlook, FY 2011 President's Budget, p. 2.

²⁰ Testimony of Karen Lee, NASWA president and Commission of the Washington State Employment Security Department before The Committee On Finance, United States Senate, April 14, 2010.

²¹ 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.

²² Federal taxes will apply to wages paid in the year shown, if the trust fund is insolvent on November 10th of that year.

²³ Michigan did not have an outstanding balance on January 1, 2007 but did have an outstanding balance on January 1, 2008. Michigan repaid that balance on May 1, 2008 but then began borrowing later in the month. Borrowing continued and MI had an outstanding balance on January 1, 2009 and did not repay by November 10, 2009. Therefore Michigan employers had a credit reduction that applied to 2009 FUTA wages.