

NPRM Summary and Analysis

SUMMARY:

- Issue: The United States Department of Labor has published a Notice of Proposed Rulemaking (NPRM) that would require states meet certain criteria in order to qualify for “cash-flow” loans.
- NPRM: The proposed rule would require that States meet a solvency criterion in one of the 5 calendar years preceding the year in which advances are taken; and meet two tax effort criteria for each calendar year after the solvency criterion is met up to the year in which an advance is requested.
- Comments: Comments must be submitted in writing on or before August 24, 2009.

HISTORY:

- The financing objective for the UC Program is to build and maintain reserves at a level that will ensure funds are available to pay benefits during average recessions, which many States have not done, while not building reserves so high as to impede economic growth.
- The successive and deep recessions of the early 1980s found many States insolvent by mid-1983. For the first time, the entire Federal-State system was in a net negative balance position with regard to the aggregates of all State and Federal unemployment compensation trust funds accounts. Since advances were available from the Federal Unemployment Account without interest at the time, some States may have been inclined to avoid the more difficult policies required to maintain solvency.
- The Advisory Council on Unemployment Compensation, created by the Emergency Unemployment Compensation Act of 1991, reported that during the previous decade many States with low or negative trust fund reserves found themselves in a position of either increasing taxes on employers in the midst of an economic downturn, or restricting eligibility and benefits for the unemployed.
- In general, the past reviews of the Unemployment Compensation System concluded that if the forward-funding nature of the Unemployment Compensation System is not restored the shift in financing methods has the potential to dramatically increase borrowing, leading to interest charges and tax credit reductions at points in the business cycle when these additional costs to employers would be difficult to cope with and would also precipitate reductions in UC benefits. Both of these results would reduce the UC program’s economic stabilization effect.
- Under sec. 1202(b)(2) of the SSA (42 U.S.C. 1322(b)(2)), short-term advances, commonly called “cash flow loans,” are interest free if:
 - (1) The advances made during a calendar year are repaid in full before the close of September 30 of the same calendar year;
 - (2) No additional advance is made during the same calendar year and after September 30; and
 - (3) The State meets funding goals relating to its account in the UTF, established under regulations issued by the Secretary of Labor (Secretary).
 - According to the House Committee report, this amendment was intended to encourage solvency of State unemployment funds: “Should a State account become insolvent during an economic downturn, adverse conditions can result for the State and its employers. Borrowing Federal funds imposes a cost on the State at a time when it may face other financial difficulties. The State may react by raising taxes on its employers or cutting benefits, thereby discouraging economic activity during a period when its economy is already in decline. The provision would encourage States to maintain sufficient unemployment trust fund balances to cover the needs of unemployed workers in the event of a recession.” (H. Rep. No. 105– 149, 104th Cong. 1st Sess. 108 (1997).)

- Original Bill had the Solvency Criteria: The original bill (H.R. 2015, 105th Cong. sec. 9404 (1997)) specified a solvency standard that a State's UTF account had to meet in a specified past time period to obtain an interest-free advance. However, the bill ultimately enacted as the Balanced Budget Act dropped the solvency standard and timeframe, leaving it to the Secretary "to establish appropriate funding goals for States."
- USDOL's Reasoning for the New Criteria: By establishing a solvency goal, an inadequately funded State could no longer misuse the interest-free borrowing period by taking an interest free advance in one year and repaying it with funds from other sources, and then possibly repeating that process in consecutive years—thereby avoiding the payment of interest on the use of Federal funds. The adoption of an interest-free borrowing period was intended to assist those States that required only a relatively small advance for a short period of time, not to encourage States to maintain small trust fund account balances and misuse the interest-free mechanisms, which has occurred on several occasions.

OBJECTIVE

- To meet the statutory requirement and Congress's goal of encouraging States to provide for sufficient unemployment trust fund balances to cover the needs of unemployed workers in the event of a recession, the Department proposes funding goals which would encourage States to:
 - (1) Build and maintain adequate solvency levels during economic expansions; and
 - (2) avoid substantial reductions of tax effort prior to obtaining an advance.
- These proposed funding goals provide an incentive for States to increase their level of forward funding, but are not a mandate on States.
- USDOL Principals in Developing the Proposed Funding Goals:
 - Be based on currently collected data from reports approved by the Office of Management and Budget (OMB), specifically tax rates calculated from contributions and wage data reported in the Quarterly Census of Employment and Wages (QCEW) report (OMB No. 1220-0012); State trust fund account balances and benefits paid data from the ETA-2112 report (OMB No. 1205-0456) which can be used to measure adequacy of trust fund account solvency and tax effort.
 - Be based on established concepts and measures such as the reserve ratio and average high cost multiple.
 - Consider Trust Fund account balances over a reasonable period of time rather than at a single recent point in time.
 - Take into account State behavior in terms of an intentional reduction in revenues.

PROPOSAL

- The proposed funding goal consists of two parts:
 - (1) A solvency goal which requires a State to have met a specified solvency level in one of the 5 years prior to borrowing; and
 - (2) The maintenance of a specified level of tax effort (mechanics described below) in the years between reaching the solvency goal and borrowing.
- Solvency Goal: The solvency goal would require that a State have an Average High Cost Multiple (AHCM) of at least 1.0 in one of the 5 years prior to the year in which a State seeks to obtain an interest-free advance.
- Maintenance of Tax Effort Goal: The maintenance of tax effort goal is based upon two measures. The "unemployment tax rate" (UTR), defined at 20 CFR 606.3(j) as, for any taxable year, the percentage obtained by dividing the total amount of State UC taxes paid into the State unemployment fund by "total wages." The second is the "benefit-cost ratio" (BCR), defined at 20 CFR 606.3(c) as the percentage obtained by dividing all UC paid under State law during a calendar year by "total wages."
 - For a State to meet the maintenance of tax effort goal, it must satisfy two requirements demonstrating that it attempted to maintain the solvency of its UTF account through its tax system.

- (1) For each year between the last year in which the solvency goal was met and the year of the potential interest-free advance, the State's UTR must be at least 80 percent of the prior year's rate. Since the UTR is a measure of revenue generating capacity, this requirement would prohibit a State from receiving an interest-free advance if it allowed its revenue generating capacity to decline by more than 20 percent annually for any year between the last year the solvency goal was met and the year of the potential interest-free advance. A reduction in the UTR of 20 percent or less from one year to the next is considered an acceptable variation as historical data show UTR drops of this magnitude are common and largely attributable to tax schedule shifts. If the State's UTR were lower than 80 percent of the prior year's UTR for any year at issue, the State would be considered to be making insufficient efforts to fund UC.
- (2) For each year between the last year in which the solvency goal was met and the year of the potential interest-free advance, the UTR must be at least 75 percent of the average of the State's BCRs, as determined under 20 CFR 606.21(d), over the previous 5 years. This requirement supplements the first by assessing whether a State has contributed to its benefit financing problems.

JUSTIFICATION

- Justification for these Criteria: The two criteria are complementary in terms of proper trust fund management and together support the intent of the Balanced Budget Act. The two requirements together assure that the State meets the maintenance of tax effort goal by both maintaining revenue and assuring that that revenue is reasonably adequate to finance benefits.
 - The solvency goal is a measure of trust fund account adequacy at a point in time and reflects past efforts to ensure availability of funds to pay UC in an economic downturn. Legislative history shows Congressional interest in such a concept.
 - The maintenance of tax effort requirement reflects State behavior over a period of time, i.e., the period between attaining the solvency goal and needing an advance to pay UC, and is designed to avoid giving an interest-free advance to a State whose need for an advance was precipitated by a deliberate State action such as a legislated tax cut that adversely impacted trust fund account solvency. The maintenance of tax effort requirement allows for reductions that might typically occur as a result of an automatic shift in tax schedules.
- Argument in Favor of the Solvency Goal: Based upon the Department's review of historical data, going back to 1967, States having an AHCM of at least 1.0 going into a moderate recession are not likely to borrow during or after the recession.
 - None of the States borrowing during the current recession (as of June 9, 2009) had an AHCM exceeding 0.4 at its beginning, December 2007. For the solvency goal, the Department would require a State to have an AHCM of 1.0 as of the end of one of the 5 calendar years prior to the year in which it has taken the advance that could potentially qualify as an interest-free advance. Requiring that a State had met the solvency goal in one of the 5 years prior to borrowing demonstrates that the State had acted responsibly by achieving the goal in the recent past.
 - The use of the five-year requirement also recognizes that economic dynamics may be such that a State may slide toward insolvency over a period of time. The time requirement suggested by the legislative history was much shorter, but was rejected as unworkable.
 - The requirement also might enable a State to qualify for an interest-free advance in consecutive years, but no more than five, as a result of needing an AHCM of at least 1.0 in one of the 5 years preceding the advance. Because a State may qualify for interest-free advances over a 5-year period, there is ample time for it to fix its inability to adequately finance its UC program before losing access to interest-free advances.
- Argument in Favor of the Maintenance of Tax Effort: The requirement assures that the State maintained its tax efforts by keeping employer contributions at a reasonable proportion of UC paid, which assures that the State's tax structure is sufficiently functional to generate adequate revenue to cover a reasonable percentage of the 5-year average costs.

IMPACT

Overall Impact of Solvency Goals on Stakeholders: The overall impact of the funding goals will be the potential reduction in the amount of Federal subsidies going to States in the form of increased interest payments from States that no longer qualify for the interest-free borrowing period.

Importance of Solvency Published in Federal Regulations: A positive impact of the solvency criteria will be the publication in Federal regulations, for the first time, a reference to the importance of the level of trust fund solvency. Since no solvency standards currently exist in Federal statutes or regulations, this would be the first guideline that States could refer to when considering the adequacy of their UC trust fund accounts.

Determine States' Reaction to such a Proposal: Finally, State reaction to the funding goals will determine the extent to which solvency is improved and future borrowing reduced. To the extent States do react and interest-free borrowing is reduced, the policy goal of reducing the subsidy provided by interest-free advances will be achieved.

Negative Impacts on Employers and Claimants: The impact of implementation of the funding goals depends on what choices States make. If a State chooses to take no action, the State will pay more interest in the event it has a cash-flow loan, which will ultimately impact taxes and/or benefits. If a State chooses to increase its trust fund level to meet the funding goals, there are also potential impacts on taxes and benefits. Either way, the ultimate impacts fall on employers or claimants, although some of the costs for one group are benefits for the other group and vice-versa.

Employers: One identifiable cost to employers is the possible higher unemployment compensation taxes in States that may lose their current ability to receive interest-free borrowing privileges or in those States that choose to meet the funding goal requirements (line B in the table). In the first case, States would need to find a way to make interest payments as those payments may not, under sec. 1202(b)(5), SSA, be made from revenues collected to pay unemployment compensation. That might mean a separate tax on employers, or using other State money. In the second case, in States that choose to meet the funding goal criteria but currently do not, higher UC taxes (resulting from either tax increases or smaller tax reductions than might otherwise be the case) would need to be implemented.

Claimants: The funding goal could also impose a cost on workers by cutting benefits (line D in the table). States that respond to insolvency by cutting benefits may be induced to cut further because of the increased interest cost. Also, States that try to achieve the solvency criterion may cut benefits to do so (although this seems unlikely), in addition to increasing taxes. Time Period for Application of Law: The Department intends that the final rule establishing funding goals would apply 2 years after its date of publication to allow States time to adjust their financing systems if they choose to do so.

Consequences of Borrowing: Borrowing can result in undesirable actions, either voluntarily by the State or through the mandate of Federal law, at points in the economic cycle for which the actions are least bearable. Such actions might mean lowering benefits, increasing taxes, or a combination of both at a time when neither employers nor UC beneficiaries are best able to cope with the consequences.

PROBLEMS WITH JUSTIFICATION:

Data Arguments in Favor of Solvency Goal: For example, following the 1991 recession, seven states borrowed Federal funds to pay UC benefits. All seven used the interest-free borrowing period at some point in their borrowing. Following the 2001 recession (2002–2007), nine States borrowed approximately \$5 billion to pay UC benefits. All nine States that borrowed Federal funds during this period at some point received an interest-free borrowing period. Their foregone interest payments totaled an estimated \$17 million. However, this was only about 9% of the total of \$184 million in interest payments that these States made. When the proposed criteria for each approach of the funding goals was applied to these two recessions, only two of the seven States that qualified for an interest-free advance following the 1990–1991 recession would have qualified under any of the proposed approaches. Only one of the nine States that qualified following the 2001 recession would have qualified under the proposed approaches. That one state, Massachusetts, avoided only approximately \$1 million in interest payments, which represented less than one percent of all borrowing costs following this recession.

The Department conducted simulations using historical data to examine the effects of applying the three solvency approaches on the eligibility for an interest-free advance. To do these simulations, the Department created a set of annual State data from 1967 through 2007, and then examined borrowing over the period 1972 through 2007. (The earlier data were used to satisfy the proposed five-year look-back criterion.) Between 1972 and 2007, States borrowed in a total of 246 years. These individual borrowing years were then aggregated into 67 borrowing episodes (defined as periods of consecutive years in which a State borrowed). Only the first year of each episode was tested for eligibility under the three approaches, assuming that the first year of borrowing is when a State would most likely seek an interest-free advance. These episodes may have lasted for a single year or multiple years and may have required interest payments. The episodes lasted 3.3 years on average, with 17 of them being less than one year long. They have tended to become shorter with milder recessions. Information was not available to determine how many States would have qualified for interest-free advances under the existing criteria, and the States' borrowing practices may well have changed after 1982, when interest was imposed on borrowing. As a result, the analysis based on these historical data is only able to show the number of episodes for which the new funding goals would have been met in the first year, not whether States had met the other criteria for interest-free cash-flow advances that year. The results, based on the 67 borrowing episodes, are summarized below.

In 23 instances (34 percent of the time) the State would have met the funding goals for an interest-free advance in the first year of borrowing under the proposed approach.

- In 19 instances (28 percent of the time) the State would not have met the 1.0 AHCM solvency goal.
- In 9 instances (13 percent of the time) the State would have met the solvency goal, but not the maintenance of tax effort goal.
- In 16 instances (24 percent of the time) the State would have met neither the solvency goal nor the maintenance of tax effort goal. (Percentages do not add to 100 due to rounding.)