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No. 988 **April 1990**

UNEMPLOYMENT COMPENSATION IN MICHIGAN: TRUST FUND SOLVENCY

This is the first in a two-part series on unemployment compensation in Michigan. This **Council Comments** focuses upon the solvency of the state trust fund. A subsequent **Council Comments** will compare Michigan with other major states on key features of unemployment compensation.

General Background

Unemployment compensation is part of the social security system adopted by the federal government in 1935 and is intended to provide partial wage replacement to unemployed individuals with requisite attachment to the work force. Unemployment compensation was established as a self-financing program, the responsibility for which is shared by the federal and state governments which levy unemployment compensation taxes on employers, and on employees in some states.

States have substantial latitude to determine significant matters such as minimum and maximum tax rates, the wage base to which such tax rates are applied (which must at least equal the federal taxable wage base), experience rating methods, eligibility rules, and the amount and duration of benefits. Each of the foregoing factors plus the insured unemployment rate has a significant impact upon solvency -- the ability of an unemployment compensation system to generate revenues sufficient to pay benefits from its own resources. If state unemployment compensation funds are insufficient to pay benefits, the state may borrow from the federal unemployment account.

Solvency Experience In Michigan

From its inception in 1936 through the early 1970's, the unemployment compensation system in Michigan has been able to produce revenues sufficient to fund benefits. While the state did borrow $113 million from the federal government in 1958, in anticipation that trust fund reserves would be exhausted, the loans were not actually needed and were subsequently repaid. Michigan, Alaska, and Pennsylvania were the only states to borrow prior to 1970.

High levels of unemployment throughout the 1970s, caused by a series of recessions, depleted the trust fund reserves. Michigan began borrowing in 1975 to finance benefits, one of 23 states to borrow at this time. Borrowing continued until 1977, by which time the accumulated debt had reached $624 million. Statutory changes, which included several increases in the taxable wage base and maximum tax rate, together with an upturn in the economy, permitted the state to retire its debt by the end of 1979.

Entering the 1980s, the state's economy took another downturn and unemployment levels increased. The solvency achieved at the end of the 1970s was short-lived, and as a result the trust fund failed to build up a sufficient level of reserves. Michigan began to borrow again in 1980, one of 32 states to borrow between 1980 and 1985. In response to these events, legislation was

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passed in 1980 tightening the qualifying conditions for unemployment compensation. The improvements created through qualification tightening, however, were mitigated by further changes in this legislation which liberalized benefit levels. Borrowing continued for several years, with the debt accumulating to over $2.3 billion in 1983.

In 1982, the state Legislature again addressed the imbalance between revenues and benefits. Several changes were made to enhance revenues, including increases in the taxable wage base and allowing tax rates to respond faster to changes in the economy. Benefits were reduced, essentially by freezing the maximum weekly benefit amount, reducing the wage replacement ratio, and tightening certain eligibility requirements. The Legislature also enacted a solvency tax on negative balance" employers to finance interest charged on federal loans after April 1, 1982. While the changes on the tax side were permanent, the majority of changes on the benefit side expired at the end of 1986.

The interest-bearing debt was repaid by the end of 1985. Since then, the state has been retiring the $1.2 billion non-interest-bearing debt accumulated prior to 1982 through voluntary repayments from its trust fund. Payments of $166 million in 1986, $168 million in 1987, $171 million in 1988, and $179 million in 1989 has left the state with a balance of $603 million in outstanding loans. Michigan has been able to make these voluntary payments by qualifying for a waiver of the federally-imposed penalty taxes, possible because certain criteria have been met, including the trust fund not experiencing any net decreases in solvency. While the waiver has had the salutary effect of allowing employers in this state to avoid the penalty taxes, these payments have also reduced the trust fund reserves by a commensurate amount.

While Michigan remains the only state with federal loans outstanding, it is not the only state with debt outstanding. Both Louisiana and West Virginia sold bonds to repay their federal interest-bearing debt, and each instituted a special tax dedicated to servicing the bond debt. Both states substituted state debt (at lower interest rates) for the federal debt, and both are still attempting to pay off their debts.

The Relationship of Reserves to Trust Fund Solvency

The unemployment compensation system in Michigan is currently solvent and has been solvent since 1985. It will remain solvent as long as it is able to fund benefits from its own resources. Haw long this is possible in Michigan is dependent on the revenues collected and the adequacy of the reserves in the trust fund. It may be argued that necessity for reserves is inversely related to the level of experience rating of the tax system, since under a highly experience-rated system an increase in benefits due to rising unemployment should trigger a corresponding increase in employer taxes and, thus, revenues to finance them. This response is not instantaneous, however. It is during the period before tax revenues are able to respond to unemployment increases that trust fund reserves are needed to fund benefits. Rising unemployment may, during this intervening period, render insolvent a system with inadequate reserves and require that benefits be financed through other means, such as borrowing. Because the experience rating in Michigan is based in part on a five-year average of chargeable benefits, the period during which tax rates respond to increases in unemployment is relatively long and, therefore, requires a significant level of trust fund reserves to avoid insolvency.

Adequacy of Trust Fund Reserves

Two generally accepted measures of the adequacy of a state's unemployment compensation trust reserves are the high-cost multiple measure and the months of benefits in trust fund reserves measure, developed by the U.S. Department of Labor. It is beneficial to consider the adequacy of Michigan trust fund reserves from these two perspectives.

High-Cost Multiple The high-cost multiple measures how long the state's historically highest-level benefits could be paid from its current reserves, exclusive of any outstanding debt. Michigan has a history of operating with less than optimal trust fund reserves as measured by the high-cost multiple. Not since 1968 has Michigan had reserves sufficient to pay benefits for a full year, and not since 1957 have reserves been sufficient to pay benefits for 18 months. During the early 1970s, Michigan generally had about six months of reserves on hand. When solvency was regained in 1979, Michigan was able to accumulate barely enough reserves to fund a full month of benefits. It was not until 1986 that the state again had a positive high-cost multiple, which has been increasing slowly since. The current reserves in Michigan of $1.2 billion as of December 31, 1989, are sufficient to pay a little less than six months of the state's highest recession-level benefits.

Months of Benefits in Trust Fund A second measure of trust fund reserve adequacy is months of dollar benefits in the trust fund. While the high-cost multiple measures how long historically high benefit levels could be paid, the months of benefits in the trust fund measures how long benefits could be paid at current levels if benefits continued at their most recent levels and no additional funds were collected. Reserves fare much better under the latter measure, with current reserves adequate to pay 15 months of benefits.

Forty-three other states currently have reserves adequate to pay at least six months of benefits and 21 of those states could pay benefits for at least a full year under the pessimistic high-cost multiple measure. Only four states and the District of Columbia rank below Michigan under the high-cost multiple measure. Similarly, only three states and the District of Columbia appear to be in as bad or worse shape than Michigan under the months of benefits in trust fund measure. Because these measures tend to show a best- and worst-case picture of the adequacy of the reserves, the actual level of benefits in reserve probably lies somewhere between these two measures. Reserves are low in Michigan relative to most other states, and no other state is using reserves to repay its debt. In light of the fact that Michigan has experienced several consecutive years of economic growth, the relative lack of reserves is a legitimate source of concern.

Matters Affecting Trust Fund Reserves

Several factors account for the state trust fund's relative lack of reserves: the drop in average tax rates as a result of lower unemployment; the use of trust fund reserves for the voluntary repayment of non-interest-bearing debt; and the structural imbalance between revenues and expenditures, due to the indexing of benefits without similar treatment being given to taxes. Each of these factors is examined in more detail below.

Average Tax Rates Sixty percent of an employer's tax rate in Michigan is based upon benefits charged to that employer during the last five years as a percentage of that employer's taxable wages during the same period. Like the nation as a whole, Michigan has experienced relatively strong economic growth and relatively law unemployment over the past six-to-seven years. This

economic recovery has been of long enough duration that years of high benefit payments have been replaced by years of more modest benefit payments, thus reducing average tax rates and, therefore, revenues. The average tax rate as a percent of taxable wages has been reduced from 5.7% in 1985 to 3.8% as of December 31, 1989. Lower tax rates have resulted in an absence of excess revenues available for the accumulation of reserves.

Debt Repayment Michigan has been retiring its non-interest-bearing debt by making voluntary payments from its trust fund. While this approach has had the salutary effect of avoiding federal penalty taxes on employers, these payments have also reduced trust fund reserves by a commensurate amount. Since 1986, these voluntary repayments have totaled $684 million. Thus, revenue which could have served as a bulwark against future borrowing has been expended to retire existing debt.

Structural Imbalances Another factor accounting for the inability to maintain a significant level of reserves is the structural imbalance that exists between revenues and expenditures. The maximum weekly benefit amount is indexed to 58% of the state average weekly wage, while the taxable wage base is not indexed. This is not to suggest that the taxable wage base ought to be indexed, but merely that an imbalance exists by indexing only benefits. A public policy argument can be made that neither should be indexed and it should be a legislative responsibility to periodically review the adequacy of both benefits and taxes.

While it can be expected that benefits might exceed revenues during a recession, in general tax rates should produce revenues in excess of benefits during periods of economic recovery. However, because benefits are indexed, while revenues are not, it is conceivable that benefits could exceed revenues in periods of recovery as well, thereby limiting the ability of the system to produce reserves.

The costs to the states associated with insolvency has changed from what it was prior to the early 1980s. In the past, because of the availability of interest-free federal loans, borrowing to finance benefits during times of insolvency carried no additional costs and was not a serious concern. However, federal loans are now interest-bearing if used for more than cash-flow purposes. If the system should become insolvent in the future and require loans from the federal government, the repayment of these loans with interest will mean additional costs at a time when most employers can least afford it.

Policy Implications

A degree of uncertainty exists concerning the condition of the unemployment compensation system in Michigan, due mostly to the fact that the current system is largely untested. The system has been changed in several ways from the system in place during the last recession, and since Michigan has gone through several years of economic recovery, the demands on the system have been minimal. Not until the state undergoes a period of high unemployment will this system be tested and the adequacy of the trust fund measured.

In the short-term, the system appears to be operating as well as can be expected: it is solvent; borrowing does not appear to be a need in the near future; and there are reserves available for voluntary repayments. However, in the long run, trust fund reserves may continue to be at relatively low levels; a structural imbalance threatens long-term solvency; and Michigan continues to deplete its reserves by making voluntary repayments from the trust fund. Although there are no

immediate threats to solvency, it would seem prudent to monitor the status of these items to prevent the need to deal with them in a crisis situation.

The policy of using the trust fund for voluntary repayments might be evaluated. By applying for the waiver and using recent revenue to repay past debt, the future solvency of the system is threatened. The waiver allows employers to avoid paying the federal penalty taxes. However, if the reserves Michigan might need in the future are insufficient, the cost of borrowing could be greater than a short-term increase in employer costs associated with current payments of the penalty tax. Employers may not have the same ability to pay these additional costs in the future as they have during an economic recovery.

The structural imbalance earlier noted between revenues and benefits could be addressed. Should it be deemed important that benefits keep pace with inflation, then it would appear prudent to accord similar treatment to the taxable wage base. Alternatively, both benefits and taxes might be made subject to periodic legislative review, or made subject to changes in the solvency of the system. In Illinois and Pennsylvania, for example, there are a series of triggers in trust fund levels that adjust taxes or benefits, or both, to prevent insolvency.

Similarly, that tax rate component which is based upon a five-year rolling average of benefits as a percent of taxable wages might be examined. Many other states rely upon an average covering a shorter time frame. As a result, changes in the benefit levels have a more immediate effect upon tax rates, resulting in shorter lag times during which reserves are needed to fund benefits. States with shorter rolling averages theoretically have less need for a large accumulation of reserves. Alternatively, these states experience greater fluctuations in their tax rates.

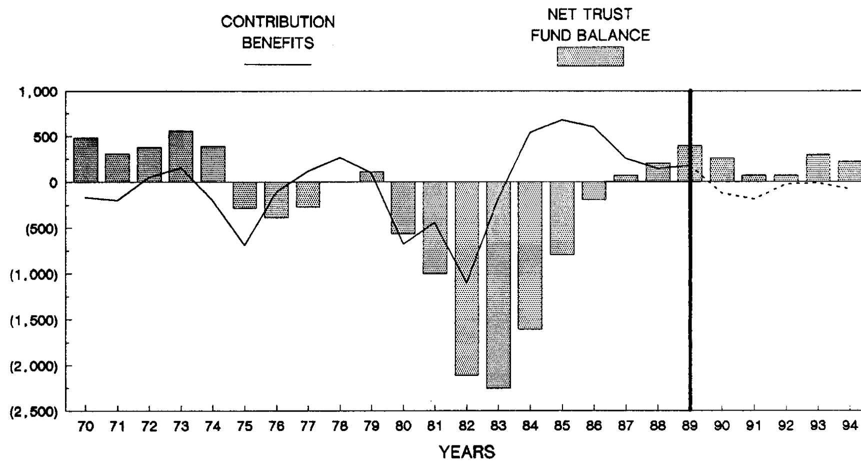
The beneficial reasons for accumulating adequate reserves are fairly straightforward, unless it becomes the public policy of the state that benefits be financed with interest-bearing loans during times of high unemployment.

Future Projections

The Michigan Employment Security Employment Commission has projected the status of the trust fund through the year 1994 based on the economic forecasting of the Research Seminar in Quantitative Economics of the University of Michigan. Assuming the continuation of present law, it is projected that the debt can be repaid by 1992, by 1994 reserves will have declined to just over $200 million, and in every year from 1990 through 1994 unemployment benefits will be greater than employer contributions.

ANNUAL GAP BETWEEN EMPLOYER TAXES AND UNEMPLOYMENT COMPENSATION BENEFITS PAID AND CUMULATIVE STATUS OF MICHIGAN'S UNEMPLOYMENT COMPENSATION FUND: 1970-1994

(in millions of dollars)



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