Council Comments

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UNEMPLOYMENT COMPENSATION IN MICHIGAN – 1. THE FISCAL CRISIS

IN BRIEF

The financing of the Michigan Unemployment Compensation Fund has reached a critical stage. While benefits to the unemployed will continue to be financed from a combination of unemployment taxes collected from employers and borrowings from the federal government, the fund is plunging ever deeper into debt. The state faces a triple threat:

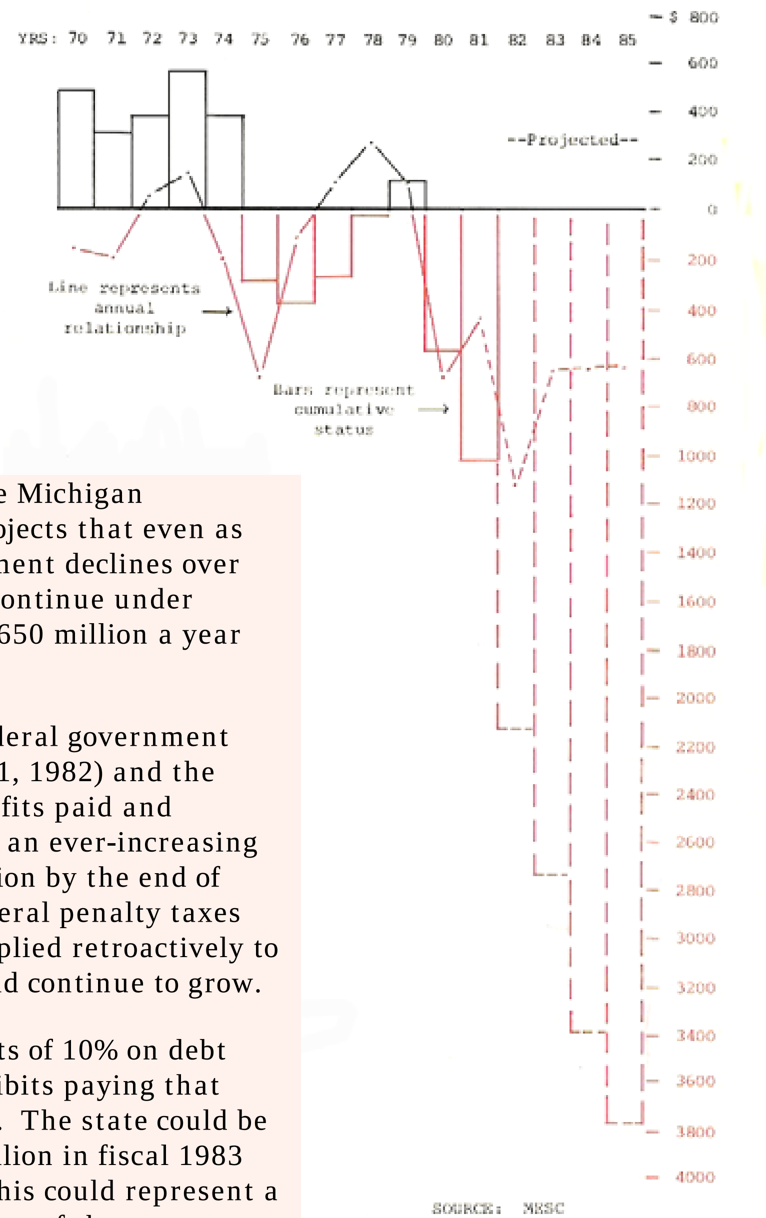
1. The system is basically out of balance. Current benefits paid exceed current taxes paid into the fund (by an estimated $1.1 billion in 1982) and the Michigan Employment Security Commission projects that even as the economy improves and unemployment declines over the next three years, the system will continue under present law to pay out an estimated $650 million a year more than it takes in.

2. The system is deeply in debt to the federal government ($2.2 billion estimated by December 31, 1982) and the basic imbalance between current benefits paid and current taxes received would result in an ever-increasing debt (projected to reach almost $4 billion by the end of 1985). Under present federal law, federal penalty taxes will be imposed beginning in 1983, applied retroactively to 1982 taxable wages, but the debt would continue to grow.

3. Federal law requires interest payments of 10% on debt incurred after April 1, 1982, and prohibits paying that interest from the unemployment fund. The state could be facing an interest bill of about $80 million in fiscal 1983 which will escalate in future years. This could represent a claim on the general fund and taxpayers of the state.

Chart 1

ANNUAL GAP BETWEEN EMPLOYER TAXES AND UNEMPLOYMENT COMPENSATION BENEFITS PAID AND CUMULATIVE STATUS OF MICHIGAN'S UNEMPLOYMENT COMPENSATION FUND — 1970-1985 (in millions of dollars)



The state faces the challenge of closing a $650 million annual gap between income and outgo, retiring the $2.2 billion accumulated debt to the federal government at an annual rate of $500 million or so over the next four-to-five year economic cycle, and paying $80-to-$200 million a year in interest costs to the federal government. This will tax the ingenuity of state policymakers, as well as the pocketbooks of employers, employees and, potentially, the general taxpayers of the State of Michigan. The crisis in the financing of the Michigan Unemployment Compensation Fund must be resolved and the methods chosen must be those that will minimize the damage to the Michigan economy and its ability to provide jobs for the citizens of Michigan.

This Council Comments examines the nature of the unemployment fund financing problems confronting Michigan. Subsequent Comments will examine how Michigan compares with other states and some of the alternative solutions that are being proposed.

THE GAP BETWEEN INCOME AND OUTGO

As shown in Chart 2 (opposite page), benefit payments exceeded taxes paid in both 1980 and 1981 and are projected by the Michigan Employment Security Commission to continue to do so in the future under current benefit-tax provisions even as unemployment levels decline in future years.

Closing the gap between current benefits payments and taxes to avoid further increases in the debt must be the first order of priority. The retirement of the accumulated debt cannot be addressed effectively until the current hemorrhaging is stopped.

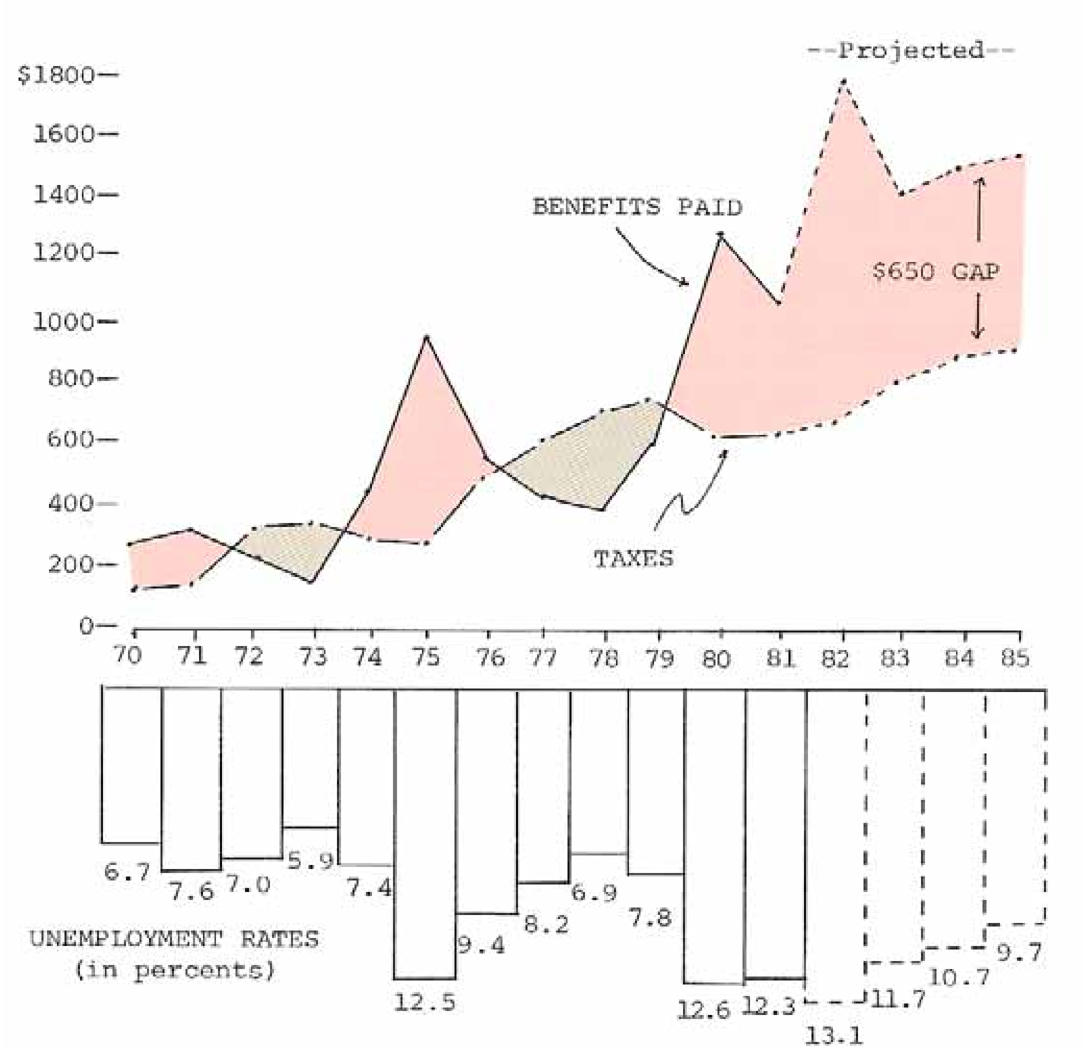
The current recession with its high levels of unemployment has contributed to the problem of unemployment benefit payments exceeding taxes — high unemployment both increases total benefit payments and reduces the total amount of wages subject to taxation. the gap between benefit payments and taxes is not, however, solely a result of current high unemployment levels (estimated 13.1% in 1982), since a gap of about $650 million each year continues throughout the projection period (see Chart 2) while unemployment declines steadily to an estimated 9.7% in 1985 (estimates of unemployment rates from "Employment Plan of the Governor," January 1982).

While short-term fluctuation in taxes received and benefits paid can be expected to occur, over the course of an economic cycle revenue should at least equal benefit obligations. Taxes in Michigan have not equaled or exceeded benefit costs since 1979 and, under current provisions, are not expected to do so. The MESC estimates that under the current benefit-tax structure, total current benefit payments and taxes would be in equilibrium only if the unemployment rate declined to 6.5%. From 1970 to date, the Michigan unemployment rate has been at 6.5% or less in only one year (1973) and the average unemployment rate (1970-1981) has been 8.7%. It appears unlikely in the near or intermediate term that Michigan will have an unemployment rate that averages 6.5% over a business cycle.

The levels of benefit payments and taxes provided under current law are basically out of balance at the levels of unemployment reasonable anticipated in the future.

Chart 2

EMPLOYER TAXES AND TOTAL UNEMPLOYMENT
COMPENSATION BENEFITS PAID - 1970-1985
(in millions of dollars)



<u>Benefit Increases Added to the Problem</u>

In 1977, 1978, and 1979, total taxes received exceeded benefits paid and the state was able to payoff the $624 million debt it had accumulated during the 1975 recession and to build up a $109 million reserve in 1979. In December 1980, however, the legislature amended the unemployment compensation act to liberalize benefit payments effective March 1, 1981. The maximum weekly benefit was changed from a flat dollar amount ($97 to $136, depending on the number of-dependents) to a percentage (58%) of the average weekly wage in the state, which had the effect of indexing future benefits.[1] The maximum benefit for a single person doubled between 1980 and 1982 and indexing will cause the maximum benefit to continue to increase as shown in Table 1.

The average weekly benefit has also increased sharply under the 1980 amendments, from $102 per week in 1980 to an estimated $160 per week in 1982. Based on the projection of an average annual increase of 7% in average weekly wages, the average weekly benefit will continue to rise and will be $196 per week by 1985, almost double the 1980 figure.

Table 1

Maximum and Average Weekly Unemployment Compensation Benefits

Calendar	Maximum	Average Weekly
1980	$97 - $136*	$102
1981	$182	$128
1982	$197	$160 est.
Projected:		
1983	$211	$171
1984	$226	$183
1985	$242	$196

* Varies, depending on number of dependents. The 1980 amendments provided a maximum benefit that does not take into account the number of dependents.

Source: MESC projections and CRC calculations.

The increase in and the indexing of maximum weekly benefits and the resulting increases in the average weekly benefit explain why total benefit costs will continue to rise even as unemployment declines in future years.

Indexing Benefits without Indexing the Base or Rate Compounded the Problem

When the legislature increased benefits in December 1980, it took no action to correspondingly increase taxes paid into the fund. The taxable wage base of $6,000 per employee and the tax rate which ranges from 1.0% to 9.0% were unchanged. Thus, both before and after the 1980 amendments employers pay a tax ranging from $60 to $540 per employee earning $6,000 or more per year. Michigan has a system that uses modified experience-rating to determine the actual tax paid by each employer. In a pure experience-rated system, each employer would be fully

[1] The benefit increases and certain other sections of the J980 amendments are scheduled to terminate (sunset) March 31, 1983. The maximum benefit would reverty back to the $97-$136 per week level. The MESC projections assume that the current provisions will not sunset.

responsible for funding the benefits used by its employees in Michigan. However, once an employer's experience-rated tax rate reaches 4.0%, a "limiter" is applied which prevents the rate from increasing by more than 0.5 percentage points a year. Both the "limiter" on rate increases and the maximum 9.0% rate inhibit the indexing of tax rates to correspond to increases in benefits paid. Thus, the average tax rate as a percent of taxable payroll (shown below) has remained relatively stable despite the sharp rise in unemployment benefits paid (as shown in Chart 2).

Calendar	Average Tax Rate As a Percent of Taxable Payroll ($6,000 all years)
1978	4.1%
1979	4.0%
1980	3.7%
1981 (Preliminary)	4.0%
1982 (Estimate)	4.1%

Source: MESC; 1982 estimate by UBA.

Thus, the average tax rates in 1981 and 1982 (4.0% and 4.1%), when the two-year total in benefits paid is $2.8 billion, are the same as the average rates in 1978 and 1979 (4.1% and 4.0%) when the two-year total of benefits paid ($1.4 billion) was only half as large.

> The gap between benefits paid and taxes received is the result of indexing benefits, while the taxable base is not indexed and the rate of increase in the tax rates is limited.

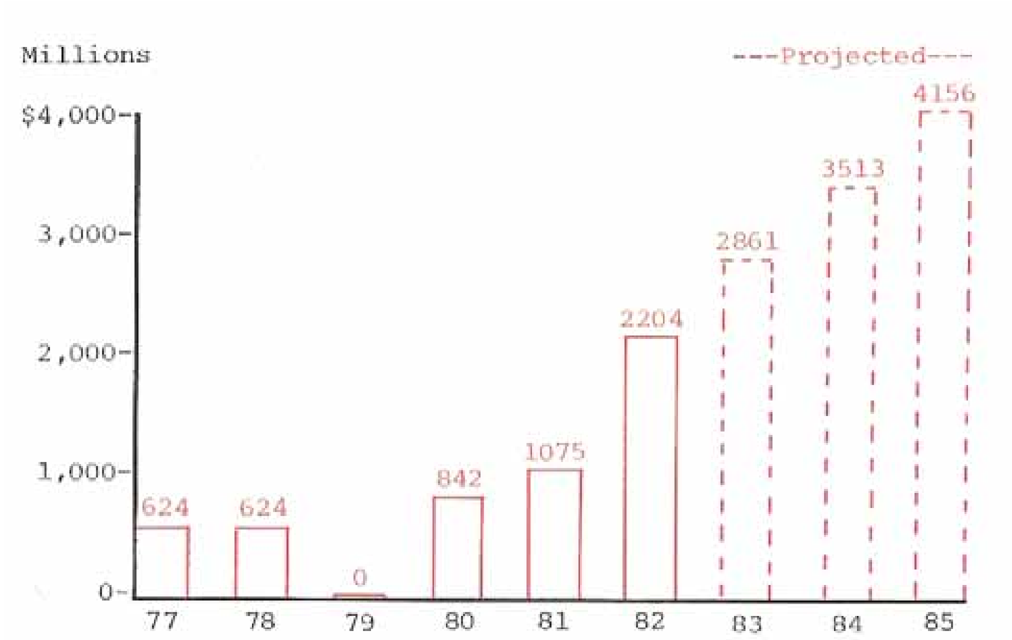
The magnitude of the gap between benefits paid and taxes received of about $650 million annually over each of the next three years is so great that extraordinary measures are needed to close it. More than a 40% reduction in benefits or a 75% increase in payroll taxes, or some combination of the two, are required simply to bring current benefit payments and current taxes into balance. This would hold the accumulated debt at the 1982 level of $2.2 billion and further benefit reductions or tax increases would be required to payoff the accumulated debt.

THE ACCUMULATED FEDERAL DEBT

Michigan's Unemployment Compensation Fund was $1.1 billion in debt to the federal government as of December 31, 1981, and it is estimated that this will increase to $2.2 billion by the end of 1982. The Michigan Employment Security Commission projects that, under the current benefit-tax provisions, the debt will continue to increase by about $650 million each year from 1983 to 1985 as a result of the gap between benefits paid and taxes received. By the end of 1985 the debt would be about $4 billion (see Chart 3, page 6).

Chart 3

TOTAL LOANS OUTSTANDING FROM FEDERAL GOVERNMENT
AS OF 12/31 -- IN MILLIONS



Source: MESC. Excludes effect of federal penalty taxes.

As shown in Chart 3, in 1979 Michigan was able to payoff, from balances in the fund, the $624 million debt it incurred during the 1975-76 recession. Of the current debt, $842 million has been outstanding since 1980.[2] Under present federal law, unless the loans are repaid by November 10 of the second calendar year that they are outstanding, the normal federal effective tax rate of 0.7% is increased by 0.3 percentage points each year up to a maximum total federal tax rate of 3.4%. The 0.3 percentage points penalty tax increments come due at the end of each January, but are assessed against the prior-year taxable wages. The federal payroll tax is assessed against the payrolls of all employers, irrespective of the experience rating of individual employers. Michigan is continuing to borrow from the federal government to meet current obligations and will not be able to repay its outstanding loans which will be approximately $2 billion by the November 10, 1982, deadline.

Thus, the federal payroll tax on all employers in Michigan will increase by 0.3 percentage points on 1982 payrolls, payable by the end of January 1983.

[2] The state debt (Chart 3) has always exceeded the amount of the fund deficit (Chart 1) because the state has borrowed not only to cover the deficit, but also to aid the cash flow of the fund.

The 0.3 percentage points increase in the federal tax on January 31, 1983, will cost Michigan employers an additional $50 million annually. Under present federal law and projections of the debt of the Michigan fund, the tax will increase by another 0.3 percentage points to 0.6 on January 31, 1984 (annual cost to employers of $100 million).

Capping the Federal Penalty Tax in 1984

The federal penalty tax increment of 0.3 percentage points a year iup to a maximum penalty tax of 2.7%) continues until the debt is repaid. However, present federal law permits the penalty tax to be capped at 0.6% (and remains at 0.6% until December 31,1987) provided that the state meets four requirements.

> It is unlikely that Michigan will be able to meet the requirements for capping the federal penalty tax at 0.6% in 1984; thus, the penalty tax will continue to escalate.

The Federal Solvency Test

Present federal law also provides for a solvency test. The increase in the federal penalty tax is normally limited to 0.3 percentage points a year. However, if a state system has been insolvent as of January 1 for five consecutive years (which Michigan will be on January 1, 1985), the rate the following year could jump all the way to the maximum federal penalty tax of 2.7%. Based on current projections, it is possible that Michigan will be unable to meet the solvency test and the penalty tax rate could jump immediately to the maximum 2.7% on 1985 payrolls, payable in 1986.

> Unless Michigan is able to finance its outstanding debts to the federal government over the next several years, it faces across-the-board penalty taxes on all Michigan employers beginning in 1983 that will escalate rapidly in future years. The penalty tax on employers could increase from 0.3% in 1983 ($50 million) to as much as 2.7% in 1986 ($500 million) if Michigan fails to meet the solvency test.

INTEREST ON THE DEBT

The third problem facing Michigan in financing its Unemployment Compensation Fund is the payment of interest on the debt to the federal government. Borrowing from the federal government was an attractive alternative to fund solvency and reserve accumulation because prior to April 1, 1982, loans were not subject to interest. A state could borrow from the federal government without interest and later repay the loan with inflation-cheapened dollars. The federal government now charges interest of 10% on new borrowing. While Michigan has interest-free loans of $1,563 million (borrowed before April 1, 1982), its borrowings since April 1, 1982, will be subject to 10% annual interest payments. The Michigan Employment Security Commission projects that the amount of interest-bearing loans outstanding as of December 31 under current benefit and tax provisions will rise from $641 million in 1982, to $1.2 billion in 1983, to $1.9

billion in 1984, and to $2.6 billion in 1985. As of September 30, 1983, Michigan will have incurred interest charges of about $80 million Under current projections, the annual interest charge would approach *$200* million by September 30, 1985.

Current federal law prohibits payment of interest charges from the Unemployment Compensation Fund. The interest must be paid either by a special, separate tax on employers, by the state general fund, or by some other special financing method.

> Interest on the Unemployment Compensation Fund debt to the federal government represents about an $80 million cost in fiscal 1983, which could increase to $200 million by fiscal 1985, that must be financed outside of the Unemployment Compensation Fund. This represents a potential claim on the general fund and taxpayers of the state.