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Special Commentary



State Unemployment Compensation Funds: The Fourth Leg of a Wobbly Stool

States are grappling with yet another challenging fiscal problem—their unemployment compensation (UC) funds. Many states are nearing exhaustion of their funds while some are running negative balances or have already borrowed from the federal government. California's Unemployment Insurance Fund deficit, forecasted by the state agency to reach \$18.4 billion at the end of 2010, is about the same as the state's general fund deficit.

It is possible that bad news now comes in “fours”, at least with respect to municipal finance. We are well accustomed to municipalities and their ubiquitous budget deficits, their general lack of ability to pay the annual requirement of their unfunded accrued actuarial liability (and OPEB) and the general increase in net bonded indebtedness that is underway and will continue over the next few years. The fourth source of bad news is the condition of state unemployment compensation funds.

The UC program was designed in the Great Depression as a counter-cyclical program that would provide economic stimulus in the form of wage replacement for unemployed workers when unemployment was high, and would replenish depleted balances when economic conditions were favorable. This automatic stabilizer feature appealed to economists, who sought ways of reducing business cycle volatility. Wisconsin originated the idea of unemployment insurance in 1932. Through the Social Security Act of 1935, the federal government provided motivation for individual states to adopt unemployment insurance plans. The program operates similarly to the Medicaid Program (created in 1965) since it is a joint federal state program. States are given wide latitude to structure the program, determine eligibility for wage replacement, as well as the amount of the benefit and its duration. States that conform to requirements of the federal government are allowed to borrow from the federal government should they need to replenish their unemployment compensation fund. States that do not conform cannot borrow from the federal government.

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There is enormous disparity in the income tax base that is used, the level of the employer tax and the benefits paid. Massachusetts, for example, pays \$411 per week while Mississippi pays \$197 per week.¹ The difference clearly exceeds any difference in the cost of living that might exist between the two states. Another factor that influences the decisions surrounding the management of the Unemployment Compensation program is the diverse cultural influences that come into play. Historically, states that have had higher levels of unionization tend to have a system of generous benefits. In other states benefits were smaller and eligible unemployed workers did not always use the program because of cultural attitudes about “welfare”.¹



The basic format of the program is to establish a tax on employers operating within the state. The amount of the tax, and the ceiling that is imposed on income subject to the tax, are left to the states and vary widely. The length of the benefit is also determined by the state, with the exception of special federal programs that come with program specification. In good times the tax on employers is sufficient to grow the state's unemployment compensation fund. However, when the economy turns, and unemployment compensation funds are drawn down, states can face tough choices. Additionally, if a state's unemployment compensation conforms to federal requirements, employers may receive up to 5.4% tax credit against FUTA tax rate, reducing the effective tax rate to 0.6% (current tax rate 6% of first \$7,000 in taxable wages).

One choice available to states is to borrow from the federal government. If the state is in conformance with federal guidelines it can borrow at no interest cost as long as the borrowings are repaid by the end of the federal government's fiscal year (September 30th). If the funds are required *after* September 30th, then the state must pay the federal government interest. The interest charge is determined by the federal government and relates to the cost of funds experienced by the Treasury with respect to their financing operations. States are charged on an average daily balance basis, creating an incentive to repay the loans promptly. Given that the rate is set by the federal government and relates in some fashion to Treasury issuance costs, the costs to the borrowing state are not insignificant. Also, if states have outstanding balances on January 1st for two consecutive years and balance remains unpaid as of November 9th of the second year, employers lose increments of 0.3% of their tax credit each year until federal advances are repaid. This is yet another incentive to finance the repayment through the public debt markets.

Selected Interest Rates and Interest Rate Spreads, 1990-2004

Year	Interest Rates							Basis Point Spreads			
	Title XII Loans (1)	Moody's AAA Corporate Bonds (2)	S&P High-Grade Municipal Bonds (3)	Three-Year Treasury Securities (4)	One-Year AAA Municipal Notes (5)	Three-Month Treasury Bills (6)	One-Month Commercial Paper (7)	Title XII Less Municipal Bonds, (1)-(3) (8)	Corporate Bonds Less Municipal Bonds, (2)-(3) (9)	Municipal Bonds Less One-Year Municipals, (3)-(5) (10)	Title XII Less One-Year Municipals, (1)-(5) (11)
1990	8.70	9.32	7.25	8.26	NA	7.75	NA	145	207	NA	NA
1991	8.60	8.77	6.89	6.82	4.69	5.54	NA	171	188	220	391
1992	8.05	8.14	6.41	5.30	3.02	3.51	NA	164	173	339	503
1993	7.45	7.22	5.63	4.44	2.52	3.07	NA	182	159	311	493
1994	6.90	7.97	6.19	6.27	3.53	4.37	NA	71	178	266	337
1995	6.83	7.59	5.95	6.25	3.98	5.66	NA	88	164	197	285
1996	6.71	7.37	5.75	5.99	3.62	5.15	NA	96	162	213	309
1997	6.71	7.27	5.55	6.10	3.72	5.20	5.57	116	172	183	299
1998	6.51	6.53	5.12	5.14	3.48	4.91	5.40	139	141	164	303
1999	6.45	7.05	5.43	5.49	3.46	4.78	5.09	102	162	197	299
2000	6.45	7.62	5.77	6.22	4.30	6.00	6.27	68	185	147	215
2001	6.42	7.08	5.19	4.09	2.76	3.48	3.78	123	189	243	366
2002	6.27	6.49	5.05	3.10	1.64	1.64	1.67	122	144	341	463
2003	6.08	5.66	4.75	2.10	1.05	1.03	1.11	133	91	370	503
2004	5.98	5.63	4.68	2.78	1.42	1.40	1.38	130	95	326	456

Sources: Economic Report of the President (Table B-73, January 2004); Federal Reserve Bank of St. Louis (<<http://www.stlouisfed.org/>>).

Notes: Data for all years are annual averages except for Title XII loans in 1997-99, which refer to the fourth quarter. Each percentage point of an interest rate equals 100 basis points. NA: Data not available.

The Unemployment Compensation program federal borrowing mechanism is not the only alternative available to states in dire times. One alternative is to increase either the tax on employers or the base upon which the tax is applied. Another alternative, of course, is to cut benefits. Raising taxes and/or reducing benefits, however, is not an optimal policy response in the middle of a recession.

The Economic Dynamic of UC Funds

The Unemployment Compensation program was part of the Social Security Act of 1935 passed during President Roosevelt's administration. Faced with issues of states' rights and the high level of federal-

ism during that time, the federal government allowed states wide berth to structure their program. The federal government mandated a minimum income base, but states could use a higher base if they so chose.

This format worked well for decades. Gradually, however, the inexorable rise of inflation created a fundamental problem for the financial stability of the program. The income base upon which the tax is applied is not indexed for inflation (unless, like Oregon and 15 other states, the state legislatively establishes that as part of its program). Wage levels, however, continued to rise both with inflation and with the general rise in the standard of living over those many decades. In recent years the current federal government mandated minimum income tax ceiling has been \$7,000. When the average wage was \$15,000, the provision of unemployment compensation funds to the unemployed was at least adequate to assist in providing basic support to the unemployed and, in aggregate, for reasonable economic stimulus during recessions. Many states, however, have chosen not to increase the ceiling, or have increased it very modestly relative to the growth in the wage base. This dynamic has led to an unsustainable trend towards less financially stable programs. The current condition of unemployment compensation trust funds relates more to the recent management of the program than it does to the current recession. The notable exception is the relatively small subset of mostly western states that chose to index their ceiling to inflation.⁵

How Did States Get into This Mess?

During the Carter Administration states were allowed to borrow at no interest cost indefinitely from the federal government to rebuild their UC funds that had been depleted during the severe recession of 1974-75. Recognizing a good thing, many states kept their borrowings outstanding indefinitely. This came to a crashing end in the early 1980s when the federal government amended the program to require interest charges on average daily balances outstanding beyond the current federal fiscal year end of September 30th. This resolved the issue substantially, with states paying off their borrowings.

Summary of Trust Funds, Borrowing, and Solvency Legislation in Selected States as of December 31, 2004

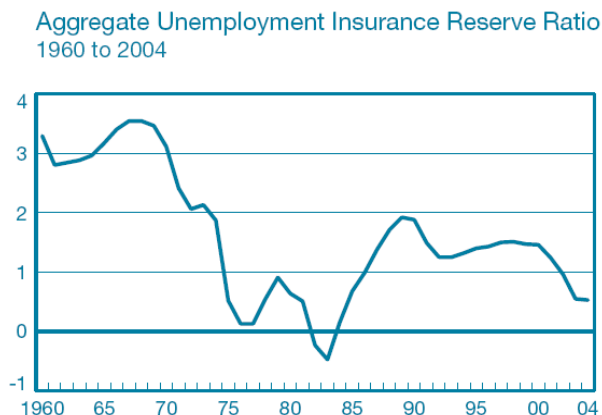
	State Size Rank	Reserve Ratio		Change in RRM, (3)-(2)	Year of First Loan	Unemployment Insurance Debt (Millions of Dollars)		Experience Rating Response	Solvency Legislation	Bond/Note Authorization	Bond/Note Issuance
		Multiple (RRM), 12/00	RRM, 12/03			12/03	12/04				
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)	(11)
Panel A: States that have borrowed											
California	1	0.51	0.09	-0.43	2004	0	0	Yes	No	No	No
Illinois	5	0.42	-0.10	-0.52	2003	511	712	Yes	2003	Yes	Yes
Massachusetts	13	0.55	0.02	-0.54	2004	0	0	Yes	2003	No	No
Minnesota	15	0.50	-0.11	-0.61	2003	176	123	Yes	2003	No	No
Missouri	19	0.36	-0.10	-0.46	2003	143	288	Yes	2004	Yes	No
New York	2	0.16	-0.10	-0.26	2002	751	691	Yes	No	No	No
North Carolina ^a	12	0.69	-0.07	-0.76	2003	172	269	Yes	No	Yes	Yes
Pennsylvania	6	0.58	0.15	-0.43	2004	0	0	Yes	No	No	No
Texas	3	0.24	-0.19	-0.43	2002	1,400	1,167	No	2003	Yes	Yes
Panel B: States with low reserves at end of 2003											
Arkansas	33	0.42	0.09	-0.33		0	0	Yes	2003	No	
Colorado	21	0.91	0.15	-0.76		0	0	Yes	No		
Connecticut	22	0.41	0.20	-0.21		0	0	Yes	No		
Michigan	9	0.59	0.24	-0.35		0	0	Yes	No		
Ohio	7	0.50	0.19	-0.31		0	0	Yes	No		
Virginia	11	0.84	0.17	-0.67		0	0	Yes	2003	No	

Sources: U.S. Department of Labor, Office of Workforce Security; information gathered by author.

^aNet reserves in December 2000 include \$200 million in the state's reserve fund.

The politics of the era and weak political will began to take its toll on many state UC funds during

the period that followed. For some states, the popularity of supply side economics lead to a reduction in the tax on employers under the premise that lower employment taxes would boost economic activity and aid in drawing business relocations from other states. For other states with higher UC balances, the impulse to raise unemployment compensation benefits proved to be too great. More costly benefits in these states, without a proportional increase in taxation, guaranteed problems in any ensuing recession. Businesses lobbied hard to keep state UC funds low, thinking that if the funds stayed low it would discourage states from raising benefits.



Source: U.S. Department of Labor, Office of Workforce Security.

Note: The chart shows the reserve ratio minus net reserves as a percentage of payroll, as of December 31.

The Reed Act and Recent Changes to the Program

In 2002 the Reed Act was created. The act allows states to use trust fund monies for other reasons than payment of UC benefits, such as administration of the program and worker adjustment programs. The monies in state UC trust funds that come from tax receipts, however, must be used to pay benefits. The ARRA liberalized repayment requirements, charging borrowers no interest through 2010.

Policy Alternatives

There are several policy alternatives available to state governments who are running low on UC funds. The most basic alternative, assuming the state is running their program in accordance with federal guidelines, is to borrow from the federal government. This alternative has the advantage of not costing the state anything until borrowings extend beyond the current federal fiscal year ending September 30th, at which time the state has to pay about 4% on average daily balances.

The second choice is to borrow in the public debt markets by issuing short term fixed rate or variable rate securities. At the present time, for almost all states, the borrowing cost, including all associated fees, will be below the federal borrowing rate, providing some arbitrage earnings. Only about a half dozen states have taken advantage of this alternative since the Carter Administration in the late 1970s, and many new potential borrowers will have to pass enabling legislation in order to have the authority to borrow.

A third choice, not widely used, is to borrow internally. Pennsylvania has done this successfully by borrowing from their Motor License Fund in 2004.³ This mechanism may require new legislation for many states and may provide only small benefits (eliminating costs of debt issuance) over other alternatives. In today's environment of severely depleted state funds—general, enterprise, and other—this alternative may be available to only a few states.

Loans to Unemployment Insurance Programs from the Private Capital Market

State	Issuance Year (1)	Loan Authori- zation (2)	Loan Amount (3)	Loan/ Payroll ^d (4)	Maximum Bond Maturity (5)	Fixed-Rate Bonds (6)	Variable- Rate Bonds (7)	Some Bonds Callable? (8)	Some Bonds Convertible? (9)	Year Fully Repaid (10)
Recessions before 2001										
Louisiana	1987	1,315	1,315	6.3	2002	Yes - 1,315		Yes		1994
West Virginia	1987	258	258	3.2	1993	Yes - 258		Yes		1991
Connecticut	1993	1,142	1,021	2.6	2001	Yes - 450	Yes - 571	Yes	Yes	2001
2001 recession										
Texas	2003	2,000	1,400	0.5	2009	Yes - 800	Yes - 600	Yes	Yes	
North Carolina	2003	^b	172 ^b	0.2	^b					
	2004	^b	269 ^b	0.2	^b					
Illinois	2004	1,400	712	0.4	2013	Yes - 340	Yes - 372	Yes	Yes	
Missouri	2004	450	^c							

Source: Information supplied to author by individual states.

Note: Dollar amounts are in millions.

^dLoan amount is expressed as a percentage of total state payroll of taxable covered employers in year of issuance.

^bBorrowing authorized by administrative action. Amount determined on an "as-needed" basis. \$172 million was borrowed in 2003; \$269 million was borrowed in 2004. Notes were repaid in the year following their issuance, using unemployment insurance tax receipts.

^cNothing issued as of January 2005.

It is important to note that there are two critical economic impacts when a state borrows from the federal government beyond the interest waiver date. The first is the heavy interest charges, potentially as high as \$600 million for the State of California, for example.² The second is that taxes on employers have to be increased to repay the federal government. The increase in tax rates can be very significant, sometimes as much as 35%. States will often judge that increased taxes are less desirable than borrowing in the public market to repay federal borrowings.

The "Hail Mary" Pass

The American Recovery and Reinvestment Act of 2009 extended the period of no cost loans from the federal government through the end of the calendar year 2010. Some states will no doubt anticipate an extension of the federal waiver beyond 2010. In fact, Congressman Welch of Vermont is expected to propose federal legislation that would maintain the borrowing rate at zero through 2012. This avenue will likely be viewed as a service to state governments, especially Vermont, which is running a sizable UC deficit of its own. The downside of the legislation, however, is that relying on the federal government to act as "*deus ex machina*" subjects troubled state finances to another harsh blow if the legislation fails to pass.

Financing Strategies Used by States Accessing the Public Markets

Loans from the Treasury carry interest as determined by Title XII of the Social Security Act. The rate, as previously mentioned, is applied on average daily balances. Most of the time, short term municipal financing rates will be significantly below these Treasury rates, which are rooted in Treasury financing costs. For example, from 1991 through 2004, interest rate on Title XII loans was, on average, about 373 bps higher than the 1-year AAA muni yield.

Potential Volume of Borrowing

At present (late January) more than two dozen states' unemployment compensation trust funds are "in the red".⁴ The list of those in deficit are:

OUTSTANDING STATE LOANS FROM THE FEDERAL UNEMPLOYMENT ACCOUNT					
State	Balance as of Jan. 20, 2010	Began Borrowing	State	Balance as of Jan. 20, 2010	Began Borrowing
Alabama	175,231,403	15-Sep-09	Nevada	182,980,871	26-Oct-09
Arkansas	253,484,709	16-Mar-09	New Jersey	1,116,462,333	5-Mar-09
California	6,609,787,397	27-Jan-09	New York	2,390,311,852	13-Jan-09
Colorado	3,301,584	20-Jan-10	North Carolina	1,723,115,635	11-Feb-09
Connecticut	235,417,206	13-Oct-09	Ohio	1,857,337,799	13-Jan-09
Florida	1,137,000,000	24-Aug-09	Pennsylvania	2,130,454,479	17-Mar-09
Georgia	139,000,000	10-Dec-09	Rhode Island	146,228,743	16-Mar-09
Idaho	130,638,625	29-Jun-09	South Carolina	735,329,771	31-Dec-08
Illinois	1,382,084,790	14-Jul-09	South Dakota	11,723,224	5-Aug-09
Indiana	1,571,497,814	11-Dec-08	Texas	1,518,593,613	22-Jul-09
Kentucky	619,037,951	28-Jan-09	Virgin Islands	9,894,845	27-Aug-09
Michigan	3,326,382,333	27-Sep-06	Virginia	169,967,000	28-Oct-09
Minnesota	372,899,650	22-Jul-09	Wisconsin	1,025,565,728	18-Feb-09
Missouri	514,461,815	27-Feb-09			
Total				29,488,191,173	27 states

Source: U.S. Dept. of Labor, Employment and Training Administration.

Loop estimates that states will borrow between \$2 and \$5 billion in the public debt markets in 2010 to avoid the high federal charges on Title XII borrowings as well as the punitive tax burden that has to be applied to business (and their lost tax credits) in order to repay borrowings. By accessing funds via the municipal market (funds may be tax exempt or taxable, like the Texas 2003 deal, depending on the purpose), the states can generate legal arbitrage and spare the negative business climate effects of an increased business tax. States are also choosing to lower benefits to help stem the bleeding.

Conclusions

State credit quality is now facing four distinct threats: general fund deficits, growing net bonded debt, increasing unfunded pension obligations (and OPEB) and unemployment compensation fund deficits. While borrowing for UC deficit problems has been confined to a handful of states in the past, it is likely that the number of states that will access funds through the public debt market will at least double to about 12 or more. Since there are numerous financing strategies, many of which are dictated by state law, it is difficult to tell how many will come to market as tax exempt or taxable and how they will be divided between fixed rate short-term notes, variable rate notes, or fixed rate bonds. We will continue to monitor the situation and issue additional reports.

Calculation of Economic Debt

State	In Millions					
	Mid-Year 2010 Budget Gap	Unemployment Trust Fund Balance	Net Bonded Debt	Sum UPBO	Economic Debt	Economic Debt Per Capita
Alabama	\$401	(\$166)	\$3,709	\$7,971	\$12,247	\$2,601
Alaska *	\$1,300	\$298	\$591	\$3,586	\$5,477	\$7,841
Arizona	\$2,000	\$169	\$5,244	\$7,613	\$14,857	\$2,253
Arkansas	\$107	(\$240)	\$1,070	\$2,765	\$4,181	\$1,447
California	\$6,300	(\$6,499)	\$66,363	\$57,927	\$137,089	\$3,709
Colorado	\$561	\$61	\$1,680	\$16,658	\$18,899	\$3,761
Connecticut	\$549	(\$197)	\$15,721	\$15,859	\$32,325	\$9,188
Delaware *	\$557	\$39	\$1,858	\$121	\$2,536	\$2,865
District of Columbia	\$150	\$330	N/A	(\$170)	\$150	\$250
Florida	\$147	(\$1,001)	\$20,445	(\$6,633)	\$20,592	\$1,111
Georgia	\$1,200	(\$121)	\$9,532	\$4,503	\$15,356	\$1,562
Hawaii	\$533	\$131	\$4,735	\$5,107	\$10,374	\$8,010
Idaho	\$151	(\$127)	\$782	\$785	\$1,845	\$1,193
Illinois	\$5,000	(\$1,373)	\$24,213	\$54,384	\$84,970	\$6,581
Indiana	\$309	(\$1,553)	\$3,071	\$10,496	\$15,429	\$2,402
Iowa	\$415	\$384	\$236	\$3,046	\$3,697	\$1,229
Kansas	\$459	\$120	\$3,262	\$5,553	\$9,274	\$3,290
Kentucky	\$1,200	(\$609)	\$6,308	\$7,422	\$15,538	\$3,602
Louisiana *	\$1,800	\$1,144	\$5,135	\$11,659	\$18,593	\$4,139
Maine	\$209	\$335	\$978	\$3,030	\$4,217	\$3,199
Maryland	\$936	\$135	\$8,489	\$10,493	\$19,918	\$3,495
Massachusetts	\$600	\$234	\$28,093	\$10,492	\$39,185	\$5,943
Michigan *	\$2,800	(\$3,211)	\$7,663	\$9,517	\$23,192	\$2,326
Minnesota	\$209	(\$363)	\$4,520	\$14,464	\$19,556	\$3,714
Mississippi	\$370	\$470	\$4,344	\$7,921	\$12,635	\$4,280
Missouri	\$690	(\$501)	\$3,962	\$9,223	\$14,376	\$2,401
Montana *	\$434	\$167	\$378	\$1,457	\$2,269	\$2,327
Nebraska	\$155	\$168	\$30	\$715	\$900	\$501
Nevada	\$67	(\$142)	\$2,248	\$7,282	\$9,739	\$3,685
New Hampshire	\$38	\$18	\$691	\$2,519	\$3,248	\$2,452
New Jersey	\$400	(\$1,047)	\$31,438	\$19,222	\$52,107	\$5,984
New Mexico	\$650	\$281	\$2,767	\$4,615	\$8,032	\$3,997
New York	\$3,200	(\$2,349)	\$56,931	(\$11,218)	\$60,131	\$3,077
North Carolina *	\$1,505	(\$1,704)	\$7,670	(\$2,378)	\$9,176	\$978
North Dakota *	\$785	\$99	\$228	\$547	\$1,560	\$2,412
Ohio	\$296	(\$1,822)	\$11,049	\$25,795	\$38,962	\$3,376
Oklahoma	\$550	\$489	\$1,863	\$13,173	\$15,586	\$4,227
Oregon *	\$4,200	\$1,050	\$6,086	(\$6,457)	\$10,286	\$2,689
Pennsylvania	\$450	(\$2,014)	\$11,828	\$13,724	\$28,016	\$2,223
Rhode Island	\$400	(\$144)	\$1,904	\$5,012	\$7,460	\$7,083
South Carolina	\$439	(\$725)	\$4,029	\$10,956	\$16,150	\$3,541
South Dakota *	\$32	(\$11)	\$221	\$193	\$456	\$561
Tennessee	\$96	\$168	\$1,448	\$1,603	\$3,147	\$500
Texas *	\$3,500	(\$1,478)	\$12,646	\$27,099	\$44,724	\$1,805
Utah	\$279	\$493	\$1,223	\$1,052	\$2,554	\$917
Vermont	\$28	\$23	\$430	\$461	\$919	\$1,478
Virginia	\$1,800	(\$101)	\$6,073	\$11,014	\$18,989	\$2,409
Washington	\$2,600	\$2,596	\$13,667	\$3,870	\$20,137	\$3,022
West Virginia	\$100	\$124	\$1,905	\$4,384	\$6,389	\$3,511
Wisconsin *	\$3,200	(\$999)	\$8,043	\$321	\$12,562	\$2,222
Wyoming	\$32	\$155	\$45	\$376	\$453	\$833

(*) In the event that we did not have a mid-year 2010 budget gap we used the previous budget adoption gap.

Economic Debt = Mid-Year 2010 Budget Gaps +
+ (Negative balances on the state unemployment trust fund balance/ Positive balances are treated as zero) +
+ Net Bonded Debt + (Negative balances in the SUM UPBO/ Positive balances are treated as zero)

Sources:

Mid-Year 2010 budget gaps: cbpp.org
State Unemployment Trust fund balances: ncls.org
Net Bonded Debt: Moody's 2009 State Debt Medians
Sum UPBO: Individual State 2008 Comprehensive Annual Financial Reports
Population: census.gov

Sources

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- ² ProPublica, “State Unemployment Insurance Funds Founder After Years of Poor Planning”, Olga Pierce, June 4, 2009.
- ³ “The Recession of 2001 and Unemployment Insurance Financing” by Wayne Vroman, FRB New York, August 2005.
- ⁴ ProPublica, “Two Dozen States’ Unemployment Funds in the Red, Nine More Within Six Months”, Olga Pierce, January 20, 2010.
- ⁵ Department of Labor: Comparison of State Unemployment Laws as of January 1, 2009 <http://www.ows.doleta.gov/unemploy/uilawcompar/2009/comparison2009.asp>

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