

– NELP Briefing Paper –

**Bond Financing For Insolvent
State Unemployment Insurance Trust Funds**

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National Employment Law Project

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National Employment Law Project (NELP) is a non-profit legal and policy organization based in New York City. NELP has advocated on behalf of low-wage and unemployed workers for over 30 years. NELP's Unemployment Insurance Safety Net Project supports expanding unemployment insurance programs by furnishing advice and assistance to legislators and their staff, policymakers, advocates, unions, community groups, and others involved in state-level reform efforts as well as monitoring federal legislative and administrative developments.

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Executive Summary

As a result of the recent economic downturn, about a dozen states have depleted their unemployment insurance (UI) trust funds. In past downturns, most states relied upon federal loans to cover the costs of increased benefit payments that exceeded the capacity of state UI trust fund reserves. Six states required federal loans in 2003. Other states are facing borrowing if the labor market doesn't pick up soon.

More recently, a few states have used state revenue bonds issued in the private market to limit or avoid federal loans. Three states have done so during past economic downturns and two more states are currently using bonding. Others are considering bonding. Given the growing interest in private bonding to finance insolvent state UI trust funds, NELP has prepared this briefing paper to help policymakers and advocates better understand bonding as a potential alternative to traditional financing through federal loans. We make the following key findings and recommendations:

- As a matter of policy, state UI trust fund solvency is critical to the ability of trust funds to provide adequate income replacement and economic stimulus without cutting benefits or raising taxes during a recession. Conversely, maintaining low trust fund balances gives employers a favorable political opportunity to seek benefit cuts and eligibility restrictions in order to address insolvency and avoid higher UI payroll taxes. For this reason, using bonding as a means of avoiding UI trust fund solvency is bad policy for states and jobless workers.
- State flexibility under federal borrowing is a considerable advantage that can get lost in a simple cost comparison between interest rates for private borrowing and federal loans. Significantly, federal loans bear interest only on their average daily balance, not the total amount of loans borrowed. And, interest-free federal "cash flow" loans are available until September 30 each year. Making use of these features, states can reduce the costs of trust fund borrowing.
- The costs of bonds include underwriting, insurance, and servicing costs that are not present in federal loans. These fees differ based upon the maturities of the underlying bonds and whether or not the bonds are for a fixed term or callable bonds. In general, the longer a bond's maturity the more expensive the interest, and callable bonds normally have higher interest premiums as well.
- Texas has adopted bonds as a way to continue its low UI payroll taxes while under funding its state UI trust fund. "Savings" flowing from the Texas bonding arrangement are principally intended to prevent employers from bearing the costs of higher solvency assessments due in 2004 and subsequent years under previously existing UI tax laws. At the end of its bonding experience, Texas will still be relatively insolvent.
- Insolvent states' best strategy probably includes a combination of maintaining the lowest possible average daily loan balance while employing federal cash flow borrowing prior to September 30. During the last calendar quarter, states can use short-term debt instruments to obtain sufficient funds to avoid interest-bearing federal loans, repaying the short-term debt with higher UI revenues in the next year or consolidating these short-term debts with other loans.

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Introduction

The 2001 recession and continuing job slump significantly increased state unemployment insurance (UI) benefit payments over the last three years. As a result, state UI trust funds are feeling the strain, and six states took loans in 2003 from the federal treasury to refill their state UI trust funds. Other state UI funds are facing borrowing in coming months if the job market does not improve soon.

States with insolvent trust funds have traditionally relied upon federal loan arrangements that were provided under federal UI law. Using increased UI payroll taxes, benefit cuts, or some combination of these, states then repaid federal loans and returned their trust funds to solvency. In the late 1980s, Louisiana and West Virginia used state bonds to replenish their UI trust funds and reduce their reliance upon federal borrowing. Connecticut followed suit in 1993.

With the ongoing job slump, two states are using bonds in the private market to avoid and/or to repay federal loans. Texas issued \$1.4 billion in bonds in September 2003 to repay \$400 million in existing federal loans and to replenish its trust fund. Illinois adopted legislation authorizing up to \$1.4 billion in bonds in December 2003. With a number of other states facing UI trust fund solvency challenges, some are considering using state revenue bonds to finance their state UI trust funds.

Proponents of bonds, including major brokerage firms, claim that they provide lower costs than borrowing from the federal treasury. More than a simple comparison of current interest rates is required in order to fully evaluate the costs and benefits of using bonds to finance state UI trust funds. This briefing paper provides an overview of state practices used for UI financing, background information on state UI trust fund solvency, and past state UI bonding arrangements. The paper then explains how to evaluate bonding as a UI financing mechanism. As a matter of overall policy, we question the wisdom of using long-term bonds as a way to finance state UI trust funds when those arrangements are primarily designed to ensure lower employer taxes, rather than as a means to restore state trust fund solvency.¹

ABC's of UI Trust Fund Financing

Unemployment insurance is financed by state and federal payroll taxes. State UI trust contributions are financed by taxes that are "experience rated," meaning that firms' tax rates rise when they have higher levels of UI claims filed by their former employees. In addition, most states' UI tax rates take into account the reserves in a state's UI trust fund. State UI trust funds are maintained as an account in the U.S. Treasury. State reserves earn federal interest and federal loans to less solvent states bear identical interest charges.

Unemployment insurance is a federal-state social insurance program. UI programs are financed through employer payroll taxes.² The federal tax (Federal Unemployment Tax Act, or FUTA) is a uniform excise tax imposed on the first \$7000 of payroll. The effective FUTA rate is 0.8 percent and it is payable in January on

the prior year's wages. State taxes are imposed on taxable wage bases ranging from the \$7,000 federal minimum to over \$30,000. Unlike the uniform federal tax, state UI taxes are "experience rated," meaning that a firm's UI tax rate is determined in part by the levels of UI benefits paid to the firm's former employees. Most state UI taxes also take into account the level of reserves in a state's UI trust fund.

The traditional method of financing state UI trust funds is using state UI payroll tax contributions to accumulate reserves in a state's UI trust fund. Unemployment insurance programs are essentially self-financing, in the sense that UI benefits are financed through employer UI payroll taxes that are retained in a state UI trust fund. State UI payroll taxes are experience-rated, meaning that they increase to some degree when benefit payments go up and state trust fund reserves fall. Correspondingly, taxes fall when state reserves are higher and UI claims are lower.³

State UI trust funds are retained as an account for each state in the U.S. Treasury. Funds remain until they are used by a state to pay regular state UI benefits. The federal treasury pays federal interest on state UI trust fund balances. States pay identical interest rates to the federal treasury if required to borrow interest-bearing debt when their state UI trust funds are inadequate to keep up with UI benefit payments. (In some circumstances, interest-free "cash flow" borrowing can occur on a shorter-term basis.)⁴ As we discuss further, state UI trust funds are legally dedicated under state and federal law solely to UI benefit payments.

Unemployment Insurance Solvency in the Current Downturn: The Good, The Bad & The Ugly

In the UI financing field, "solvency" involves making a judgment about the sufficiency of state UI trust fund reserves to fulfill UI benefit payment requirements in a future economic downturn. Solvency benchmarks compare trust fund balances to past history and current wages as indicators of future funding requirements. A majority of states enter 2004 with adequate trust funds, with about a dozen states' trust funds facing solvency challenges. These dozen states each entered the recent recession with trust fund balances below recommended levels.

Recessions provide the litmus test for state UI trust fund reserves. Recessions offer significant challenges for UI trust fund reserves. First, UI claims levels climb significantly, often doubling in a relative short time. Second, the duration of claims increases during downturns, as jobless workers require more time to find work. Third, as layoffs spread, taxable payrolls decline, and state UI payroll tax revenues fall. For these reasons, states are well advised to take trust fund solvency into consideration well before an economic downturn causes unemployment levels to rise.

Evaluating trust fund "solvency" requires a judgment about the sufficiency of UI trust fund balances to meet UI benefit requirements in a future downturn. UI financing experts have developed solvency benchmarks that assist in making solvency assessments. The box on the next page explains the basic terminology used in discussing UI solvency.

Analyzing UI Trust Fund Solvency

The following terms are commonly used to analyze UI trust fund solvency:

*The **Reserve Ratio or Trust Fund as Percent of Total Wages** is a state's trust fund balance as a percent of total wages for the past 12 month period. Trust fund reserves are compared with state wages, roughly estimating the size of the trust fund balance to the risk being insured by UI (loss of wages). Reserve ratios are useful solvency measures because they reflect the amount of wages insured against loss by a state's UI program. There is no accepted reserve ratio level among solvency experts, although a pre-recession reserve ratio of at least 2.0 is wise in our view.*

***Cost multiples** compare the size of past UI benefit payments in a twelve-month period to trust fund balances. There are two cost multiple benchmarks in common use. A **High Cost Multiple (HCM)** of 1.0 means that a state has one year's reserves at its historically highest level of benefit payments without relying upon UI payroll tax revenues. An HCM of 0.5 converts to six months, an HCM of 1 equals 12 months, and so forth. In the 1950s, an HCM of 1.5 was widely accepted as a prudent level of pre-recession UI reserves.*

*The **Average High Cost Multiple (AHCM)** was adopted in the 1990s in light of concern that HCMs were overly conservative measures of solvency. A state's AHCM is the average of the three most recent high cost calendar years that include either 3 recessions or at least 20 years' history. The Advisory Council on Unemployment Compensation, a federal advisory panel, recommended in 1995 that states maintain a pre-recession AHCM of 1.0.⁵*

An illustration of the “rainy day” aspect of UI financing is provided by the operation of UI programs during the recent economic downturn and continuing job slump.⁶ The most recent recession officially began in March 2001. States entered the recession with significant trust fund reserves, ending calendar year 2000 with \$54.05 billion in UI trust funds. These balances resulted in a reserve ratio of 1.4, an average high cost multiple of 0.9, and a high cost multiple of 0.6. As we discuss in detail in the box above, all of these indicators were below recommended levels for pre-recession solvency. In other words, overall state UI reserves were below recommended levels prior to the 2001 recession and the current job slump.

UI claims rose rapidly in 2001 from pre-recession levels and have not yet returned to pre-recession levels. Total state UI benefit payments were \$27.34 billion in fiscal year 2001, rising to \$41.99 billion in fiscal year 2002, \$41.60 billion in fiscal year 2003, and remaining at a projected \$40.84 billion in FY 2004. State UI tax revenues were less volatile than benefit payments. In fiscal year 2001, state UI taxes totaled \$20.82 billion. State UI taxes were \$20.91 billion in FY 2002, \$25.42 billion in FY 2003, and are estimated at \$31.73 billion in FY 2004. By the end of the third quarter of 2003, state trust fund overall reserves had fallen to \$28.1 billion, taking up the slack between UI benefit payments and UI taxes. This produced a national reserve ratio of 0.75 at the end of the third quarter of 2003 (September 30), or a little more than half the pre-recession reserve ratio.

The use of overall national figures obscures good performance in terms of solvency by a majority of states and poor performance by a minority of states. For example, while nationally 0.75 percent of total wages were held in state UI trust funds at the end of the third quarter of 2003, 28 of the 53 UI jurisdictions exceeded this national average reserve ratio. Of these, 14 states (Alaska, Delaware, Hawaii, Iowa, Louisiana, Maine, Mississippi, Montana, New Mexico, Oregon, Puerto Rico, Vermont, Virgin Islands, and

Wyoming) had reserve ratios over 2.0 percent of state total wages, an impressive level of trust fund reserves at this point in the ongoing job slump.

Judging by their reserve ratios at the close of the third quarter 2003, one dozen states face pressing solvency challenges in 2004. Illinois, Minnesota, New York, and North Carolina had no reserves. Arkansas, California, Colorado, Massachusetts, Texas⁷ and Virginia had reserve ratios below 0.4, and Alabama and South Dakota were only somewhat higher. During 2003, six of these states (Illinois, Minnesota, Missouri, New York, North Carolina, and Texas) used federal UI loans.⁸

Interestingly, each of the dozen states facing solvency challenges in 2004 had lower than recommended reserves as they entered the recent recession. At the end of 2000, five states (Illinois, New York, North Dakota, Texas, and West Virginia) had average high cost multiples of 0.5 or less. Eight states (Alabama, Minnesota, Missouri, Nebraska, New York, North Dakota, South Dakota, and Texas) had reserve ratios below 1.0 at the end of 2000 (when the national reserve ratio was 1.4.)⁹ So, of the states currently facing solvency challenges Alabama, Illinois, Minnesota, Missouri, New York, South Dakota, and Texas were showing definite indications of solvency trouble prior to the current downturn. Of the remaining five states (Arkansas, California, Colorado, Massachusetts, and North Carolina) facing current solvency challenges, all except Colorado had below-average high cost multiples (0.55 or less) at the end of 2000, and all but Massachusetts had reserve ratios significantly less than 2.0.

In summary, the majority of states have balances sufficient to avoid borrowing in 2004 and 2005, and a significant number of states maintain good balances despite the strains of the past three years. Assuming that the labor market recovers within a reasonable time frame and economic growth continues for a few years before another job slump occurs, these states' UI programs should have sufficient reserves to cover a substantial portion of higher UI claims produced during economic downturns. It is no accident that many of the states that have abandoned forward financing are states currently faced with solvency challenges and federal borrowing. In the longer term, states that avoid reaching solvency will likely undergo another cycle of borrowing in the next downturn, whether by using traditional federal loans or through state revenue bonds.

Forward Financing Versus “Pay As You Go” Financing

States traditionally use “forward financing” of their UI trust funds. In other words, in order to build up reserves, states collect more UI payroll taxes during economic good times than needed to pay current UI benefits. Accumulated trust fund reserves are drawn down during economic downturns in order to meet higher UI claims and stimulate economic activity. A minority of states has adopted an opposing philosophy of “pay as you go” UI financing. These states only collect enough payroll taxes to pay current benefits, keeping trust fund balances and UI tax rates low.

The traditional means of state UI financing, which is still used by a great majority of states, is often termed “forward financing” or “advance funding.” Some use the terminology of a “rainy day fund.” In a forward-financed UI program, states accumulate trust fund reserves during economic good times. These reserves can then be used for benefit payments during economic recessions. Wayne Vroman, the nation’s leading authority on UI financing, summarizes the overall theory supporting 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

Forward financing is also intended to avoid federal borrowing in all but the more severe recessions, in order to stay away from the federal loan interest charges and attendant higher state UI taxes that usually go with repaying federal loans.

UI Financing Terminology

Forward Financing. *A philosophy that supports building up UI trust fund balances during economic good times in order to pay higher benefit claims during economic downturns. States using forward financing try to collect trust fund reserves that are sufficient to avoid steep UI tax increases or federal borrowing during a downturn.*

Pay As You Go Financing. *The pay as you go financing philosophy maintains that higher trust fund balances take money out of the economy that is better left with employers. Instead of building up UI reserves, these states rely upon employers to pay higher UI taxes as claims rise during a downturn (that is, to “pay as you go”). Pay as you go states have lower UI taxes and low trust fund reserves as a matter of policy.*

Flexible Financing. *Flexible financing states utilize some combination of higher UI payroll tax rates, flexible taxable wage base levels, and UI benefit restrictions to respond to changes in the solvency of a state’s trust fund. These flexible measures go beyond older features of UI taxation like rate schedules in order to react to impending insolvency. Flexible financing is not tied to any particular overall UI financing philosophy. Flexible financing states can and do maintain adequate trust fund balances.*

The legislative history of the Social Security Act makes it clear that Congress contemplated forward funding of UI programs to achieve the purposes of the program; namely, paying UI benefits to jobless workers and stimulating the economy. According to its 1935 Senate Report, Congress understood that “The essential idea in unemployment compensation is the creation of reserves during periods of employment from which compensation is paid to workmen (sic) who lose their positions when employment slackens and who cannot find other work.”¹¹

About a dozen states have abandoned forward financing of their state’s UI trust funds. Instead, they have adopted “pay as you go” financing.¹² Some states have done so explicitly, like Pennsylvania, Texas and Illinois, while others have lowered UI taxes and trust fund balances while more or less claiming continuing allegiance to advance trust fund financing. States with *ad hoc* pay as you go financing include Massachusetts, Missouri, North Dakota and New York. In the 1990s, this minority of states all had lower than recommended levels of trust fund reserves and did not meet recommended solvency benchmarks. They maintained lower balances because they wished to lower state UI tax rates.

Many states UI programs with pay as you go financing have UI financing measures that are known as “flexible financing.” These include trust fund “targets” that raise or lower taxes while maintaining trust fund balances within a narrow range, flexible taxable wage bases, and automatic triggers of solvency taxes and benefit reductions in the event of approaching insolvency. These measures provide quick increases in UI taxes (in some cases combined with benefit cuts) that are intended to maintain UI benefit payments when trust fund reserves are low. Pay as you go financing states also rely upon federal interest-free “cash flow” loans as another backstop to ensure that UI payments can continue despite the absence of a trust fund reserve.

Pay as you go financing is a more aggressive low tax, low trust fund balance approach than flexible financing, which exists in about 30 states in some form. Flexible financing does not connote that a state has abandoned forward financing, and a number of forward financing states have adopted flexible financing measures as extra protection against federal borrowing and interest. In contrast, pay as you go financing does involve an explicit trade off between solvency and lowering UI taxes while often including targets and other features of flexible financing.

"Pay as you go" UI financing was essentially an outgrowth of supply-side economic theories. It gained some adherents in the late 1980s. Supporters of pay as you go financing argued that large UI trust fund reserves were economically inefficient. In economists' terms, trust fund balances represented a lost "opportunity cost" that were better employed by keeping state UI taxes lower. The rationale for pay as you go financing had appeal to all the traditionally interested parties involved in UI programs. Employers and most in state government wanted lower UI taxes. Many in the legislature were willing to see reduced UI taxes so long as UI benefits were not cut as well. Labor reluctantly accepted the pay as you go scheme in some states in order to avoid more painful ways for workers to contribute to restored solvency, such as benefit freezes or eligibility restrictions. The outcome was the elimination of forward funding of trust fund reserves as a goal in a minority of states.

Theoretically, under pay as you go financing the higher benefit costs associated with a recession are paid for on an ongoing basis by higher UI payroll taxes (and benefit restrictions in those states with these provisions). Since trust fund balances were not built up during economic recoveries in order to lower taxes, states with flexible financing necessarily looked to higher taxes to pay UI benefits as needed. In short, pay as you go states had implicitly chosen lower taxes in the past on the condition of having higher taxes in the event of increased UI claims. In addition, states abandoning forward financing did not view federal loans as an evil to be avoided at all costs, but counted on cash flow loans as a back up in lieu of building their trust fund reserves.

Certainly, pay as you go financing has proven effective as a means to lower employer UI taxes during the late 1990s,¹³ but its effectiveness in using current UI taxes to pay for increased UI benefit claims in lieu of trust fund balances is in serious doubt. While the likelihood of higher state UI taxes was accepted theory at the time some states were abandoning forward financing, employers and their political supporters in less than solvent states have not simply accepted higher UI taxes in the recent downturn. Instead, rather than “paying as they went,” employers and their supporters have looked to employees to share the sacrifices of solvency efforts while seeking to avoid some or all of higher UI payroll taxes needed to pay benefits in the absence of trust fund reserves.

Given a significant correlation between pay as you go financing and lower solvency, one growing aspect of the tax avoidance philosophy reflected in pay as you go financing has been bonding. Using private

borrowing as a means of amortizing employer tax increases under state UI financing rules while avoiding sterner federal loan reimbursement requirements becomes a means of again postponing the day of reckoning for employers and postponing rebuilding of trust fund balances. In effect, bonding as become a policy partner to “pay as you go” financing. As we will see, this partnership between pay as you go financing and bonding is the key policy shortcoming in ongoing developments making state revenue bonds a part of UI financing.

Traditional Federal Borrowing to Finance State UI Trust Funds

Insolvent states can borrow funds from federal UI trust funds if needed to maintain state UI payments. These federal loans or advances bear interest on their average daily loan balance throughout the year, if not repaid in fairly short order. Interest-free “cash flow” borrowing is also provided to ensure continuation of UI benefits when state UI trust funds are empty.

The federal-state UI program included provisions permitting states to borrow from federal UI funds in order to continue benefit payments in the event of state insolvency. In order to compare private bonds to these federal loans, it is necessary to understand the underlying rules governing these federal loans.

First, under federal law (Title XII of the Social Security Act¹⁴), states with UI trust funds that have inadequate reserves can draw down funds from a loan account maintained in the federal treasury for this purpose.¹⁵ These federal funds are known as loans or advances and they are deposited in state trust funds to ensure payment of state UI benefits. This federal loan account is financed with revenues derived from employer FUTA taxes.

While Federal loans to state UI trust funds are available on an “as needed” basis, they come with strings attached. First, loans that remain unpaid after the first day of the federal fiscal year (October 1) are interest bearing. The rate of interest payable is the rate of interest paid by the U.S. Treasury on state UI trust funds during the 4th quarter of the previous calendar year. The rate for 2004 will be around 6 percent.¹⁶ Second, interest on loans cannot be repaid, either directly or indirectly, from the state’s UI trust fund. For that reason, a separate state solvency tax or surcharge is usually collected and then used to repay interest on federal UI loans, and those funds cannot be part of the state’s UI trust fund. Illinois has used general revenue to pay interest and others have used state UI penalty and interest funds.

While there are strings with federal loans, they have advantages as well. A significant point regarding interest-bearing loans is that federal interest is paid on the average daily loan balance, not on the total sum of all borrowing as with bonds. This means that borrowing states can adopt a strategy of repaying loan balances on any day that sufficient revenues are available. As Wayne Vroman states, the “optimal [state] strategy is to borrow each day that withdrawals exceed receipts and repay on days that receipts exceed withdrawals. The strategy minimizes the average daily balance and leaves the fund balance at zero at the end of each day.”¹⁷ Federal borrowing, then, offers states considerable flexibility regarding maintaining UI benefit payments while minimizing the size of the amount upon which interest is potentially due.

Second, there is a significant window for interest-free federal borrowing. “Cash flow” borrowing is shorter-term federal borrowing. Federal trust fund “advances” are interest free if they are made between January 1 and September 30 of any calendar year and repaid by October 1 of the same calendar year. A common example of cash flow borrowing occurs due to the seasonal nature of state UI revenues. In most states, the

lion's share of UI payroll taxes are paid in April or May because much of wages paid in the first quarter are within the state's taxable wage base and subject to taxation at that time. In addition, UI claims are generally higher in the first quarter. To offset these seasonal factors, cash flow borrowing in the first quarter can be repaid interest free after state revenues are received with the year's first installment of quarterly UI taxes.¹⁸

Third, in the event that states do not repay federal loans promptly, an escalating surcharge on the Federal Unemployment Tax Act (FUTA) tax (normally 0.8 percent) is imposed on the state's employers. This federal surcharge is used to repay the outstanding federal loan and interest due.¹⁹ The FUTA surcharge is imposed beginning with the second consecutive calendar year (January 1) during which there are outstanding loan balances.²⁰ States can avoid imposition of the federal surcharge by making repayments that equal or exceed the amount that the FUTA surcharge would produce. The FUTA surcharge is 0.3 percent in the first year and 0.6 percent in the second year, and so forth. The surcharge continues until the loans are repaid by the state, either through the FUTA surcharges and/or independent repayment efforts of the state. Whether or not the FUTA surcharge is actually imposed, it serves as an effective federal backstop to keep states from dithering about repaying federal loans.

Using Bonds to Finance State UI Trust Funds

Since the late 1980s, a few states have turned to private bonds as an alternative to using federal loans to maintain UI benefit payments. Revenue bonds backed by a state assessment are used to repay the entire amount of loaned funds with interest. While interest rates in the private market are lower than federal interest rates, states using bonds lose considerable flexibility when determining the amounts and duration of private loans and face underwriting and other costs that are not present with federal UI loans. A possible lower-cost alternative is combining federal cash flow borrowing with shorter-term debt instruments issued directly by states.

The basic method of bonding for UI financing is to issue bonds backed by a special UI assessment. In other words, the state issues bonds secured by the future income generated by the assessment (revenue bonds), rather than bonds secured by the credit of the state as an overall entity (general obligation bonds).²¹ Proceeds from the revenue bonds are used to repay outstanding federal loans and interest and to avoid additional federal loans. State legislation is required to authorize the bonds and the UI assessment to repay them. Interest rates for the bonds are determined by private market rates for bonds in combination with the bonds' rating provided by rating agencies. Private bond interest rates are lower than federal interest on loans.

Beginning with the late 1980s downturn, states have used private market bonds as an alternative to traditional federal bonding. Bonds were used in Louisiana and West Virginia in an effort to avoid higher federal interest rates. Louisiana issued \$1.315 billion in bonds in 1987, repaying the bonds ahead of schedule by 1994. West Virginia borrowed \$259 million with revenue bonds in 1987 and repaid the bonds by July 1991. Connecticut issued about \$1 billion in bonds in 1993.²²

More recently, Texas issued \$1.4 billion in bonds in September 2003 and Illinois signed bonding authorization legislation in December 2003. Illinois intends to issue bonds in early 2004, although the amounts and maturities are uncertain at this point.²³ Not all states that have considered bonding have proceeded to issue bonds. Missouri passed UI legislation in 2003 that including bonding as well as

restrictions on UI eligibility and benefits. This legislation was vetoed by the Missouri's governor primarily because of the bonding proposal, and the legislature was not able to override the veto.²⁴

The costs of state bonds necessarily include not only the interest paid for the bonds but the underwriting and legal fees, insurance, and administrative servicing costs for the bonds. Underwriting fees and interest charges differ based upon the maturities of the underlying bonds, whether the bonds are fixed or callable, and whether they are revenue or general obligation bonds. In addition, issuing tax-exempt bonds provides a lower rate of interest than taxable bonds.

States clearly have options in determining the size of any bonding issued, the duration of debts assumed, and the mix between callable and fixed maturities. Shorter-term debt instruments provide a possible lower-cost alternative. Most states have the capability to issue shorter-term debt directly through their state treasurers or comptrollers, similar to corporate commercial paper. By using state staff, without relying upon more costly outside underwriters and financial advisors, states can avoid fees and costs associated with bonding in the private market. Texas has some variable rate and short-term instruments as options in its bonding arrangement. The degree to which these options are used remains to be seen.

Wayne Vroman's book suggests that states facing UI trust fund borrowing consider a strategy of using federal cash flow borrowing and repayment on a daily basis, repayment of all outstanding federal loans on September 30 with short-term commercial paper, continued short-term commercial loans for any further advances required until December 31, and consolidation of the short-term debts into six-month commercial paper as these debts mature.²⁵ Such a strategy would take advantage of the flexibility offered by the rules governing federal loans and the lower costs of relying upon short-term debt issued directly by the state.

In our view, this sort of strategy should be complemented with a state effort to restore trust fund solvency within a relatively short time--two or three years. Of course, this strategy requires state policymakers to force employers to "swallow their medicine" in terms of paying higher UI payroll taxes required to avoid higher levels of indebtedness and regain solvency. While politically unpalatable, it is more likely to produce a reasonably solvent trust fund at a reasonable cost rather than the long-term indebtedness found in some bond arrangements. This long-term solution is preferable to another solvency crisis in the next economic downturn. This is the likely outcome of bonding arrangements currently underway in Texas.

Legal Concerns About Bonds and UI Financing

The U.S. Department of Labor issued a recent program letter addressing legal reservations regarding aspects of bonding and UI financing. "Repayment of Non-Federal Loans," Unemployment Insurance Program Letter No. 07-04 (December 17, 2003). These legal concerns arise because federal statutes governing UI programs contain language that casts doubt upon the practice of using bonds to finance state UI trust funds. In particular, questions have focused on the federal withdrawal standard, which limits withdrawals from state trust funds to payments of compensation.

In our view, these legal concerns are not firmly laid to rest by the Department's recent pronouncement. The letter permits states to make withdrawals from UI trust funds to repay bond obligations despite the language of the withdrawal standard and the Department's previous interpretations of this federal standard. Clearly, use of state UI trust funds to repay loans does not involve a withdrawal of a cash benefit payable to an individual in relation to the individual's unemployment.

More importantly, the Department fails to address how using bonds to finance UI trust funds are consistent with the overall federal UI statutory scheme. The UI provisions of the Social Security Act and FUTA were intended to encourage states to adopt UI programs, including the forward funding of UI trust fund balances to carry out the economic stimulus and income replacement purposes of UI. Permitting the states to use bonds without regard to solvency of trust funds undercuts these national purposes of UI.

Key Policy Concerns About Bond Financing for State UI Programs

Using bonds primarily as a means of avoiding trust fund solvency and higher UI payroll taxes is bad policy. The Texas bonding plan is designed mainly as a way to stretch out higher employer taxes required to avoid more federal borrowing. As a result, bonding in Texas will not result in improved trust fund solvency. States using bonds lose flexibility provided by federal loans under Title XII and may not significantly save money in the long run. A simple interest rate comparison will not reveal the overall costs of bonds.

There are a number of factors that states and policymakers should consider when comparing the relative costs and advantages of bonds versus federal Title XII loans. First, bonding can be a means of avoiding UI trust fund solvency, rather than a way of reaching solvency. Since as a policy matter solvency is favorable for states and jobless workers, bonding to avoid solvency is bad policy. Second, not all relevant factors relate solely to interest costs. State flexibility under Title XII borrowing is a big advantage that should not be lost in a simple interest rate cost comparison between bonds and federal advances. Finally, all costs of bonding, not just lower interest rates, must be considered when engaging in cost comparisons.

Solvency Versus Tax Avoidance. A primary consideration for state policymakers and advocates for jobless workers is how bonding will impact the state trust fund's solvency. As noted earlier, adequate trust fund solvency helps states avoid federal borrowing and interest charges. A healthy trust fund enables

states to pay higher levels of UI benefit claims during downturns without resorting to raising taxes or cutting benefits when insolvency looms. To the degree that bonding proposals result in states remaining in near insolvency, rather than regaining a healthy trust fund balance, they should be avoided as a matter of policy.

These concerns are amply illustrated by Texas's September 2003 bond issuances. The Texas bonding arrangement is, by its own terms, not a means of restoring solvency to the Texas UI trust fund, but a means of amortizing the higher costs that employers implicitly agreed to bear when Texas adopted pay as you go financing in the late 1980s. As a practitioner of "pay as you go" financing in the 1990s, Texas deliberately kept its UI trust fund balance low and left UI taxes as low as possible as well. The implicit premise of "pay as you go" financing was that employers would get lower taxes during economic good times with the understanding that when higher UI claims raised costs they would pay them. In fact, the majority of savings claimed by the Texas Workforce Commission in advocating for its bonding plan is the partial avoidance of \$1.27 billion in state solvency taxes that would have been imposed upon Texas employers in 2004 under prior law.²⁶

In contrast, Louisiana used its 1987 bonding not only to avoid higher federal interest but also to restore its overall UI trust fund solvency. When Louisiana completed the early repayment of its bonds in 1994, it had a trust fund balance of \$869 million, a considerable improvement over its solvency situation throughout the 1980s.²⁷ In late 2003, Louisiana had a UI trust fund balance over \$1.5 billion and a reserve ratio over 3.5, among the best levels of trust fund reserves in the nation.²⁸

Trust fund solvency is central for jobless workers because an adequate trust fund is virtually a political necessity to gain improvements in UI programs. In 2003, New Mexico passed legislation that significantly improved its treatment of jobless workers while giving modest tax relief to employers. New Mexico was able to do so because it had the best-financed trust fund in the nation. In less solvent states, a return to solvency often involves sacrifices by workers.

For example, Illinois is currently faced with trust fund insolvency because of years of lowered employer UI taxes and neglect of trust fund solvency. Its "solvency package" passed the legislature and was signed into law in December 2003. The package imposes some constraints on UI benefit amounts despite the fact that jobless Illinois workers did not get corresponding improvements while employers got tax reductions throughout the 1990s. While most of the financial burden of solvency falls on employers under the Illinois package, Illinois does not contemplate an end to insolvency until 2010.²⁹ It is fair to say, then, that bonding in Illinois is not a step toward solvency, but an added means of keeping UI taxes from increasing sufficiently to rebuild the state's UI reserves.

Flexibility. Federal Title XII loans offer states considerable flexibility when compared to bonds. The biggest distinction between private bonding and Title XII loans is that interest is paid on the entire amount of bonds issued, while federal interest is paid only on the average daily balance of Title XII advances. Moreover, interest on bonds is due as the bonds are issued, while federal interest on some Title XII advances is avoidable and other interest is deferrable.

If a state guesses wrong about the amount of bonds required or number of years it needs bonds, it has some flexibility to call the bonds or retire them early, but it pays for this flexibility with higher underwriting fees and interest rates. In comparison, a state can borrow daily from the federal treasury and avoid or defer interest charges entirely in some cases. The federal treasury does not charge states for daily advances and repayments. There are no underwriting, legal, or insurance fees associated with federal advances.

Title XII offers states UI financing options that bonds do not. Trust fund projections are, in our experience, an inexact science. Figuring the amount of borrowing needed two or three years down the road depends upon guesses about UI claims numbers, duration of UI claims, state UI payroll tax revenues, and wage levels. If states guess too high and issue bonds, they will bear unneeded interest and underwriting costs. If they guess too low, expected savings may not materialize. In contrast, Title XII advances need only be projected for a few months and states are not bound to borrow unneeded funds.

A combination of short-term commercial paper and Title XII advances is perhaps the best means to control borrowing levels and costs of borrowing. To date, no state has fully adopted this approach. In short, Title XII advances and state bonds are not strictly comparable methods of UI financing, especially when state flexibility is considered.

Comparative Costs. Bonds are chiefly justified as a means to save federal interest charges and overall costs. At first glance, since current federal interest charges are approximately 3 points higher than state bonds, the interest savings seem self-evident.

Surprisingly, this self-evident proposition has not held true in past state experiences with bonds. Wayne Vroman examined the Louisiana and West Virginia bonds closely in his 1998 book. Vroman found that Louisiana's bond issue did not result in overall interest savings when compared to Title XII borrowing, costing \$47.6 million more than Title XII loans, while concluding that West Virginia's UI bonds produced only \$700,000 in savings. Vroman notes a number of caveats in his simulations, but his are the only careful examinations of these transactions that have been published.³⁰ Regardless of the precise dollar figures that might arise from different assumptions, Vroman's simulations show that cost savings claims by proponents of bonds must be closely scrutinized.

When comparing costs, the amounts borrowed for bonds cannot be the same as those involved in Title XII advances because federal interest on advances is paid only on the average daily balance. In contrast, bonds will be required for the entire amount of expected borrowing. Depending upon the timing and amounts of loans expected by a state, this would impact expected interest costs to a significant degree. In other words, paying higher federal interest on a smaller daily average loan balance may be cheaper than paying nominally lower market rates on larger bond issuances.

Beyond purported interest rate savings, states need to consider underwriting fees, insurance, and other costs associated with issuing bonds. These costs are not associated with federal loans. In some cases, depending upon the type and maturity of bonds involved, these fees can rise to millions of dollars. If a state handled some or all of the borrowing in house, as many states do with short-term debts, these fees can be reduced or eliminated.

Conclusion

States facing insolvency in 2004 and coming years will consider using private bonding as the impact of the slack labor markets of the last three years lingers. If past history is any indicator, bonding or other forms shorter-term private financing are tools that states may find helpful, but they are far from a total solution to UI financing challenges. In the long run, improved solvency of state UI trust funds is a worthy goal that bonding can support or undercut, depending upon the particular arrangements used by states that engage in bonding. Bonding that is designed to primarily to avoid UI trust fund solvency and keep UI taxes low is a bad policy that states should avoid.

Endnotes

¹ This paper relies especially on Wayne Vroman, *Topics in Unemployment Insurance Financing* (Kalamazoo, Michigan: Upjohn Institute, 1998). In addition, we rely upon Marc Baldwin, *Boom and Bust: Financing Unemployment Insurance in a Changing Economy* (National Employment Law Project, April 2001). Readers in search of more information on UI financing are well advised to consult these excellent sources. In addition, NELP has published a series of reports on financing of specific state UI programs, most recently Massachusetts and Illinois. This paper adopts selected portions of the Illinois and Massachusetts financing reports. All NELP publications are available on our website at <www.nelp.org>.

² Two states, Alaska and New Jersey, have small employee contributions as well as more typical payroll taxes paid by employers. Pennsylvania has an employee contribution only when its trust fund balance is low. In this paper, we speak only in terms of employer UI payroll taxes.

³ For a longer explanation of experience rating and UI payroll taxes, see Marc Baldwin, *Boom and Bust*, p. 7-11.

⁴ Wayne Vroman, *Topics in Unemployment Insurance Financing*, p. 100-104. As we discuss later, states avoid interest charges on shorter-term federal loans if they repay them under certain timelines.

⁵ Advisory Council on Unemployment Compensation, *Unemployment Insurance in the United States: Benefits, Financing, Coverage* (U.S. Department of Labor, Washington, D.C., 1995), p. 9. See also U.S. Department of Labor, Employment and Training Administration, "Reserve Adequacy," Unemployment Insurance Program Letter No. 44-81 (October 13, 1981).

⁶ The figures regarding solvency in this section are found in the U.S. Department of Labor, Office of Workforce Security, "UI Data Summary, 3rd Quarter 2003," "UI Budget Outlook, Mid-Session Review," and the "UI Data Handbook No. 384." All are available online at the Department's Office of Workforce Security website at <<http://ows.doleta.gov/unemploy>>.

⁷ As we describe later, Texas only achieved this degree of solvency by depositing \$1 billion in bond revenues in its trust fund in the closing days of the third quarter 2003.

⁸ U.S. Department of the Treasury, Bureau of the Public Debt, "UI Trust Fund Account Reports Online," <<http://www.publicdebt.treas.gov/dfi/dfiutprep.htm>> (December 31, 2003).

⁹ See Marc Baldwin, *Boom and Bust*, p. 17-18, for a discussion of the state solvency picture prior to the current downturn and a listing of the states with low reserve ratios and average high cost multiples at the end of 2000.

¹⁰ Wayne Vroman, *Topics in Unemployment Insurance Financing*, p. 10.

¹¹ Senate Report No. 628, 74th Cong., 1st Sess. (1935) at 11.

¹² For a general overview of flexible financing, see Wayne Vroman, *Topics in Unemployment Insurance Financing* (Upjohn Institute, Kalamazoo, Michigan, 1998), 35-61 and Mike Miller, Robert Pavosevich, and Wayne Vroman, "Trends in Unemployment Benefit Financing," in Christopher J. O'Leary and Stephen A. Wandner, ed., *Unemployment Insurance in the United States: Analysis of Policy Issues* (Upjohn Institute, Kalamazoo, Michigan, 1997), pp. 365-419.

¹³ Nationally, as a percent of total wages, average state UI tax rates reached their historically lowest levels in 2000 at only 0.54 percent. Marc Baldwin, *Boom and Bust*, p. 20-21.

¹⁴ United States Code, Title 42, Sec. 1201 *et seq.*

¹⁵ In addition to the text of Title XII of the Social Security Act, this section again relies upon Vroman, *Topics in Unemployment Insurance Financing*, Chapter 4; U.S. Department of Labor, Employment and Training Administration, "Payment of Interest on Title XII Loans," Unemployment Insurance Program Letter No. 11-92 (November 12, 1992); Commerce Clearing House, *Unemployment Insurance Reports*, Federal Matters, "Credit for Contributions Paid Into State Fund," ¶ 1160 (January 15, 2004).

¹⁶ According to U.S. Treasury, Office of Public Debt, the yield on 3rd quarter 2003 UI trust fund deposits was 5.9927 percent. The 4th quarter 2003 rate applicable to interest-bearing loans in 2004 will be near this range, but was not posted by the mid-January publication date for this paper. The rate for federal loans in 2003 was 6.0757 percent. U.S. Treasury, Office of Public Debt, "Quarterly Trust Fund Yields," available at <<http://www.publicdebt.treas.gov/dfi/dfiutfyield.htm>>.

¹⁷ Vroman, *Topics in Unemployment Insurance Financing*, p. 101.

¹⁸ Cash flow borrowing has a number of arcane limits. Any advances made after September 30 and before December 31 are interest-bearing loans. In addition, if the state borrows during the last calendar quarter of a calendar year, interest is due upon any funds borrowed earlier in the calendar year on the day after the later borrowing takes place. Interest due on any loans made during the last five months of any fiscal year (loans made after May 1) can be deferred until the end of the next calendar year, although interest accrues until all deferred interest is repaid. Although these rules place significant limits on cash-flow borrowing, in practice states have been able to benefit from its availability in several cases. See sources in n. 15.

¹⁹ The mechanism for increasing the FUTA tax on employers in insolvent states with outstanding federal loans is actually a reduction in the 90 percent credit that employers normally get against the FUTA tax in states with UI laws conforming to the requirements of FUTA. United States Code, Title 26, Sec. 3302(c)(2). However, the resulting federal tax increase on a state's employers is commonly referred to as a FUTA solvency tax or surcharge.

²⁰ United States Code, Title 26, Sec. 3302(c)(2).

²¹ For background on state revenue bonds, we rely upon Judy Wesalo Temel: The Bond Market Association, *The Fundamentals of Municipal Bonds, 5th Edition* (New York: John Wiley & Sons: 2001).

²² This section again relies upon Vroman, *Topics in Unemployment Insurance Financing*, especially pp. 104-118.

²³ Concerning the Texas arrangements, Senate Bill 280 (effective June 30, 2003) was the authorizing legislation. The Official Statement regarding the bonds is available at the website of the Texas Public Finance Authority <<http://www.tpfa.state.tx.us>>. See also Texas Workforce Commission, "UI Trust Fund Financing in Texas," (December 2, 2003), <<http://www.naswa.org/sections/pdf/2003/uidirconf03p20.pdf>>. The Illinois legislation is House Bill 810 (December 26, 2003). The Illinois bonding request for proposal is available on the Governor's Office of Management and Budget website. Governor's Office of Management and Budget, "Request for Proposals to Provide Underwriting Services," (December 4, 2003) at <<http://www.state.il.us>>. The RFP gives useful details regarding bonding in Illinois.

²⁴ Missouri State Senate, "Senate Substitute No. 2, Senate Bill No. 2; Actions and Bill Summary," available at <<http://www.senate.state.mo.us>>; Governor Bob Holden, "Governor's Veto Letter (July 9, 2003)," available at <<http://governor.mo.gov/legis03/SB2vl.htm>>.

²⁵ Vroman, *Topics in Unemployment Insurance Financing*, p. 109.

²⁶ The Texas bonding legislation created a separate "obligation assessment fund" that will receive the funds from an experience-rated assessment set by the state agency. The assessment fund will pay the interest on the bonds, insurance, administrative expenses, and any federal interest on future federal loans to Texas. Under its authority, Texas borrowed just under \$1.4 billion in September 2003. It deposited most of the proceeds into its trust fund, repaying \$400 million borrowed by the UI trust fund in the first nine months of 2003. As a result, the \$400 million federal advance was rendered interest free and \$17 million in federal interest charges were avoided.²⁶ In addition, by depositing the proceeds in its UI trust fund (borrowed at rates ranging from a variable rate of 1.15 percent up to fixed rate bonds at 2.72 percent), Texas is essentially using interest rate arbitrage to get approximately 6 percent in federal interest on its borrowed funds. Texas Public Financing Authority, "Official Statement" and Texas Workforce Commission, "UI Trust Fund Financing in Texas," *supra* n. 23.

²⁷ Vroman, *Topics in Unemployment Insurance Financing*, Table 4-2, p. 112.

²⁸ Solvency is not the only criterion for assessing UI programs. Louisiana is solvent not only because it raised sufficient taxes to regain an adequate trust fund balance while repaying its 1987 bonds, but because it runs one of the least generous UI programs in the nation. Texas, on the other hand, has a bad UI program and is insolvent. In a UI financing context, Louisiana has a better policy than Texas, but this is not an endorsement of Louisiana's UI program. See Maurice Emsellem, et al., *Failing the Unemployed: A State by State Examination of Unemployment Insurance Systems* (Economic Policy Institute, Center on Budget and Policy Priorities, NELP: March 2001).

²⁹ The trust fund cash projections provided in the Illinois RFP show a trust fund balance of zero for December 31, 2009. Governor's Office of Management and Budget, "Request for Proposals to Provide Underwriting Services," *supra* n. 23 , Appendix B.

³⁰ Vroman, *Topics in Unemployment Insurance Financing*, p. 110-118.

Unemployment insurance trust funds. Long-standing State Financing Policies Have Increased Risk of Insolvency. GAO-10-440. Options to improve state UI trust fund financial conditions include raising and indexing the taxable wage base under the Federal Unemployment Tax Act (FUTA), which could induce many states to raise and index their own bases, and reducing the number of both employers paying very low rates and those that pay less in UI taxes than benefits paid to their former workers. Provides loans to insolvent state trust funds. Finances benefit payments to former federal and military employees. Source: ETA, Comparison of State Unemployment Insurance Laws, January 1, 2009. Colorado's Unemployment Insurance Trust Fund has run out of money before. It went insolvent in 2010 during the Great Recession. The state borrowed \$1.1 billion from the Federal Unemployment Account. The burden to pay it back wasn't on the state or taxpayers. Businesses bore the brunt of the insolvency. The idea caught on, and in 2013 Colorado issued bonds to finance the federal debt for around \$625 million. Some of that was to get the fund into solvency, but also to turn off the solvency surcharge, Gedney said. That was something we worked on with the employer community. In total, it was around \$1.7 billion that we borrowed through a combination of federal loans and the private market. The federal unemployment insurance (UI) trust fund finances the costs of administering unemployment insurance programs, loans made to state unemployment insurance funds, and half of extended benefits during periods of high unemployment. Unemployment insurance programs pay benefits to covered workers who become involuntarily unemployed and meet specified eligibility requirements, such as actively looking for work. UI is structured as a partnership between the federal government and states and territories. States and territories set the parameters of their unemployment programs within federal guidelines. Unemployment insurance trust funds went insolvent in 35 states after the most recent recession, prompting some governments to reduce benefits. U.S. economic output plunges by 29% as virus forces widespread shutdowns. After the 2008 crisis, states also asked the federal government for help in funding unemployment benefits. Some took years to pay back the loans. No state has run out of money, but state officials are planning for the possibility, the Journal reported. Connecticut's funding for unemployment benefits has declined about 30 percent since the end of February, the Journal analysis found. Get fox business on the go by clicking here. Markets. The state-Federal system of Unemployment Insurance (UI) programs has existed for 80 years. The programs in the states are financed by employer payroll taxes paid into state trust fund accounts maintained at the U.S. Treasury. These accounts are the source for benefit payments made to eligible unemployed workers. The programs operate as a partnership between state and Federal government in which state UI benefits are financed by payroll taxes paid into state trust fund accounts maintained at the U.S. Treasury. During this time the programs have faced a number of serious challenges, such as the major economic downturn that commenced in late 2007, which have placed heavy strains on the UI financing system.