Evaluation Report Summary #02-04a

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OFFICE OF THE LEGISLATIVE AUDITOR

STATE OF MINNESOTA

Financing Unemployment Insurance

January 28, 2002

Major Findings:

- Minnesota has enjoyed lower than average unemployment insurance tax rates, higher than average benefit levels, and a growing fund balance since the recession of the early 1990s. These advantages have largely been the result of historically low unemployment rates.

- Minnesota's trust fund balance, however, is not large compared with those in other states and does not come close to meeting any of the benchmarks typically used to assess fund adequacy.

Minnesota's unemployment insurance trust fund grew during the 1990s but could be depleted during a mild recession.

- Even a mild recession could deplete the trust fund and cause the fund to borrow from the federal government. The current recession may cause the fund to borrow in late 2002 or early 2003.

- Much of the problem with the unemployment insurance system involves the "base tax rate" schedule. The base rate is too often set at the minimum rate, which is insufficient to recover the costs of past benefits not recouped by "experience tax rates."

- Increasing the trust fund balance would help the state avoid future interest costs, diminish the need to raise taxes or cut benefits during a recession, and provide state policy makers with more flexibility in setting unemployment insurance tax policy.

Key Recommendations:

- The Legislature should consider changes that would ensure the maintenance of a more adequate balance in the unemployment insurance trust fund. At a minimum, the Legislature should make changes in the base tax rate schedule or the calculation of experience tax rates to ensure that the costs of past benefits are fully recovered.

- The Legislature should change the solvency tax statute to ensure that funds are always available to pay interest charges when they are due to the federal government.

- The Department of Economic Security should investigate whether the state could issue short-term debt in order to reduce the costs of borrowing from the federal government.

Report Summary:

Since the 1930s, Minnesota has paid unemployment insurance benefits to eligible workers who become unemployed through no fault of their own. The system is financed with taxes on private employers and reimbursements from public and nonprofit employers. Each private employer pays an experience tax based on its layoff experience. In addition, all private employers pay a base tax. The base tax rate for a given year depends on the balance in the state's Unemployment Insurance Program Trust Fund on the previous June 30th. The trust fund maintains a balance to ensure that the payment of benefits can continue during recessions when those benefits are most needed. The federal government provides loans to states that run out of funds but charges interest on those loans and imposes taxes on employers if those loans are not repaid in a timely manner.

Minnesota's Unemployment Insurance System Has Benefited From the State's Strong Economy

Minnesota's trust fund balance is low compared with those in other states and with accepted benchmarks.

The financing of Minnesota's unemployment insurance system has not needed significant attention since 1987. The state's strong economy during the 1990s helped build a balance of more than $700 million in the state's trust fund by the end of 2000. This balance appeared to put the fund in much better shape than during the 1970s and 1980s. During those previous decades, the state had to borrow significant amounts of money from the federal government in order to pay unemployment benefits.

The strong economy during the 1990s has been beneficial for both the unemployed and employers. Benefit levels for the unemployed in Minnesota have been significantly higher than the national average since the mid-1970s. But, during much of the last decade, private sector employers also benefited from lower than average tax rates. These lower tax rates were the result of unemployment rates that were well below national rates.

The state's trust fund balance grew from -$417 million at the end of March 1984 to $426 million in November 1990 due in large part to state and federal tax increases. A mild recession caused the fund balance to drop to $127 million by the end of March 1993. But declining unemployment rates helped the fund balance climb to $749 million at the end of November 2000. An increase in the unemployment rate during 2001 caused the balance to drop to about $434 million by the end of December 2001.

Despite Appearances, the Trust Fund Balance Is Relatively Low

The existence of a fund balance of more than $700 million has caused some to think that the fund had ample resources which could be used to pay additional benefits to certain workers. The trust fund balance is, however, small by any measure. At the end of June 2001, Minnesota's reserve ratio—fund balance divided by total wages covered by the unemployment insurance system—was about half the national average. Only five other states had lower reserve ratios.

Minnesota's fund balance is also low relative to the benchmarks that federal agencies have used to assess the adequacy of state fund balances. At the end of June 2001, Minnesota's high cost multiple—its reserve ratio divided by its highest cost 12-month period—was only about one-fourth of the recommended level. In addition, its average high cost multiple was 42 percent below the recommended level and 36 percent below the national average.

Minnesota's low ranking is not new. The state's fund balance has trailed the national averages by a significant amount over at least the last 30 years. The last time that the state's fund balance was large enough to meet one of the fund adequacy benchmarks was in 1970.

Minnesota's fund balance has not been close to meeting either of the benchmarks since then.

Even a Mild Recession Could Deplete the Fund Balance

Some critics of the benchmarks have argued that a state fund does not need to meet the benchmarks if it has flexible financing features that produce timely adjustments to taxes, and sometimes benefits, during an economic downturn. Minnesota has some of these features – an indexed tax base, a base tax rate that adjusts to changes in the fund balance, and a solvency tax triggered at a low fund balance. The indexed tax base helps taxes keep pace with automatic increases in the maximum weekly benefit amount. But, the other features are not adequate to prevent the fund from being depleted during a recession.

Unemployment rates like the ones in the early 1990s would force the state to borrow for up to four years.

In fact, even a mild recession such as the one experienced in Minnesota during the early 1990s would cause the state trust to borrow from the federal government. We estimate that, if the unemployment rates experienced during the 1990-99 period were repeated starting in 2002, the state trust fund would need to borrow about $500 million and would be in a deficit position for close to four years. The fund is not in as good a position to withstand a mild recession as it was during the 1990s. The fund's reserve ratio is lower than it was in 1990. In addition, the experience rated portion of the unemployment insurance tax is much lower than it was then and is not likely to rise to the levels of the early 1990s unless the recession continues for some time.

Our analysis also indicates that the current tax structure will be able to avoid borrowing over the next decade only if unemployment rates remain quite low. We estimate that borrowing is likely unless unemployment rates over the next ten years remain at the average rate experienced during the boom years of 1994 through 1999.

The Base Rate Tax Schedule Is a Major Problem

The key problem with Minnesota's unemployment insurance tax structure is its base tax rate schedule. The purpose of the base tax rate is to cover the benefit costs that are not recouped through the experience tax rate. In addition, increasing the base tax rate during periods when the fund balance is low is supposed to help keep the fund from being depleted.

But, under the current schedule, the base tax rate will tend to stay at the minimum rate of 0.1 percent unless the fund balance is very close to being depleted. At that rate, the base tax will not recover the benefit costs not recouped by the experience tax. As a result, the fund balance will never grow to an adequate level. In fact, unless we experience declining unemployment rates similar to the 1990s, the reserve ratio will tend to decline. The schedule is also not indexed for inflation and has not changed since 1987. Other problems include the extremely compressed nature of the schedule. The base rate can jump from its minimum value to its maximum value with only about a $100 million change in the fund balance. And even if the fund balance falls enough to trigger an increase in the base rate, it will take ten months before increased revenue begins to be collected.

There Are Good Reasons to Build and Maintain a Larger Fund Balance

Depletion of the trust fund is not a crisis situation since the federal government will provide states with loans to continue the payment of benefits. But there are good reasons to avoid borrowing. States that borrow must pay interest charges at a current rate of 6.3 percent. We estimate that the Minnesota employers could face additional interest costs totaling up to $50 million as a result of a mild recession like that experienced during the early 1990s. Furthermore, unless a recession is short,

Interest costs could total up to $50 million.

states that borrow will have to raise taxes or lower benefit levels during a recession, when employers and employees least want to see such changes. If a loan is not paid back in a timely way, the federal government will impose an escalating tax on the state's employers until the loan is fully repaid. The federal tax would reduce the state's interest costs but take away some of the state's flexibility in determining unemployment insurance tax policy.

One of the disadvantages of a larger fund balance is that it could be used to increase benefits rather than be saved and then used during the next recession. Legislators should weigh these advantages and disadvantages in considering the need for a larger fund balance. While it may be difficult to raise taxes during the current recession, we think that the Legislature should make changes to the base tax rate schedule. The minimum tax rate needs to be increased simply to make sure that the fund recoups the benefit costs not recovered by the experience tax rate.

The State Needs to Be Prepared in Case the Fund Needs to Borrow

The Department of Economic Security projects that the trust fund may need to borrow by late 2002 or 2003 due to the current recession. If borrowing occurs, the state needs to have a means of paying interest charges to the federal government. State law calls for a solvency surcharge of 10 percent on tax-paying employers in a year following a June 30th on which the fund is below $150 million. Because the federal government does not allow a state to pay interest charges from its trust fund, the solvency surcharge is the state's means of paying interest. The existing statute, however, will not always trigger the tax in time to collect revenues to pay the interest. The Legislature needs to address this problem.

In addition, the Department of Economic Security should investigate alternatives to federal borrowing. Minnesota cannot legally issue long-term bonds to pay unemployment benefits like some other states have done. But, it may be possible for the state to use short-term certificates of indebtedness combined with interest-free short-term loans available from the federal government.

The full evaluation report, *Financing Unemployment Insurance* (#pe02-04), includes the agency's response and is available at 651/296-4708 or:

www.auditor.leg.state.mn.us/ped/2002/pe0204.htm

Summary of Agency Response:

In a letter dated January 15, 2002, Commissioner of Economic Security Earl Wilson said, "The UI Trust Fund and the financing mechanisms which support it have been matters of concern to the Department of Economic Security for some time." He added, "During the last half of the 1990s, a growing trust fund, unprecedented economic growth and historically low unemployment rates masked the vulnerability of the fund."

Commissioner Wilson agreed with the report that "the base tax rate has been at the minimum rate too often." He stated, "Base tax rate increases linked to a fund solvency level rather than to a fund depletion level would address this problem, and I would recommend that the experience rate portion of the tax be similarly indexed to a solvency standard." The Commissioner noted, however, that the current project to revamp UI computer systems "is critical if policy options are not to be limited due to system constraints."

Commissioner Wilson also agreed with the report's recommendation to investigate whether the state could issue short-term debt to reduce the costs of borrowing from the federal government. But, he felt that a study should be the joint effort of his department along with the Department of Finance.