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COVID-19 and the Unemployment Insurance Trust Fund

The job loss related to COVID-19 has placed an unprecedented strain on our economy and our unemployment insurance (UI) system. The strain on the UI system creates two major policy challenges that require near-term action. First, unemployment taxes on employers are scheduled to skyrocket at the end of March, further hindering job retention and creation. Second, the state needs to repay federal loans (and associated interest) that have propped up the state's unemployment system over the last year while also ensuring the state's trust fund remains solvent and can meet benefit demand.

Governor Baker has filed legislation designed to address these related challenges. This bulletin examines the impact of COVID-19 on the state's UI system and assesses the implications of the pending legislation. In spite of the complexity of the issue, it is apparent that the UI tax schedule must be frozen prior to April 1st and now is the time to put in place a plan to repay federal loans.

Background: UI Taxes in Massachusetts

Unemployment benefits are paid from employer taxes. Employers, except for government and non-profit employers that elect to self-fund their UI costs, pay UI taxes based on the frequency with which their former employees receive benefits.

UI benefits are paid out of a dedicated Unemployment Insurance trust fund administered by the state to ensure that UI payments are protected and funds are not used for other purposes. Each year, the schedule of employer UI taxes automatically adjusts based on a formula that considers the fund's underlying solvency. Each schedule includes 45 different tax rates which correspond to the frequency with which employers use the UI system. Employers who are more likely to use the system are given a lower "experience rating" and are required to pay a higher rate. UI taxes are paid on an employee's wages up to $15,000.

Employer UI taxes are currently paid according to schedule E. Under that schedule, UI tax rates range from 0.94 percent to 14.37 percent, depending on an employer's experience rating. These rates translate to a per-employee tax of between $141 and $2,156. Massachusetts' tax rate for employers with the worst experience ratings is the highest in the country.[1]

[1] Data on state UI tax rates can be found on Table 22 of the Tax Foundation's 2021 State Business Tax Climate Index (https://taxfoundation.org/2021-state-business-tax-climate-index).

While the UI rate schedule adjusts automatically per the statutory formula, it is common for lawmakers to temporarily freeze or otherwise adjust the schedule to mitigate UI tax increases. In 2021, the rate is scheduled to move to G – the most expensive rate – because COVID-19 has depleted the fund and unemployment claims remain high.   Schedule G rates are approximately 30 percent higher than those in schedule E, but most employers would experience even steeper tax increases because their experience ratings have declined during the pandemic.

Background: The State and Federal UI Relationship

The federal government administers a UI trust fund that works in coordination with state trust funds. In order to ensure a reliable UI system, states can borrow from the federal trust fund to pay out UI benefits when state reserves run low. States must repay the federal trust fund by September 30th of the year in which the borrowing occurs, or accrue interest charges. If full repayment of loans does not occur by the following November, the Federal Unemployment Tax Act (FUTA) credit provided to employers is reduced over time and the revenue related to the credit reduction is used to repay the loan balance.[2]

Interest on federal UI loans cannot be paid from a state's trust fund and so states typically turn to additional employer surcharges to repay interest when owed. If a state misses the September 30th interest deadline, the FUTA tax credit is eliminated for all employers the following January.[3]

The federal Families First Coronavirus Response Act waived interest accrual on UI loans in 2020. The Coronavirus Response and Relief Supplemental Appropriations Act, signed into law on December 27th, further delayed accrual of interest on UI loans until March 14th.[4] As of February, Massachusetts has borrowed $2.2 billion against the trust fund, with an authorized monthly advance of $456 million.[5] Massachusetts will likely require an additional $3 billion in loans over 2021 to pay out benefits this year.

Figure 1. State Requirements for Federal UI Loans

	State obligation	Repayment deadline
Federal loans	Loans taken in 2020 and 2021	November of 2022
Interest on federal loans	Interest accrued after March 14th of 2021	September of 2021

The Impact of COVID on UI in Massachusetts

COVID-19 has had a catastrophic impact on the state's economy. Between February and April of last year, the state's unemployment rate went from among the lowest in the state's history (2.8 percent) to

[2] Typically, businesses receive a 5.4% credit against the 6% FUTA. If a state carries a UI loan balance for two consecutive Januaries, the FUTA credit is reduced to 5.1% that November. Each subsequent year a balance persists, the FUTA credit is reduced by a further 0.3%. In the 5th year, the FUTA credit is reduced more steeply

[3] Congressional Research Service. The Unemployment Trust Fund: State Insolvency and Federal Loans to States (RS22954, December 2020), (https://crsreports.congress.gov/product/pdf/RS/RS22954)

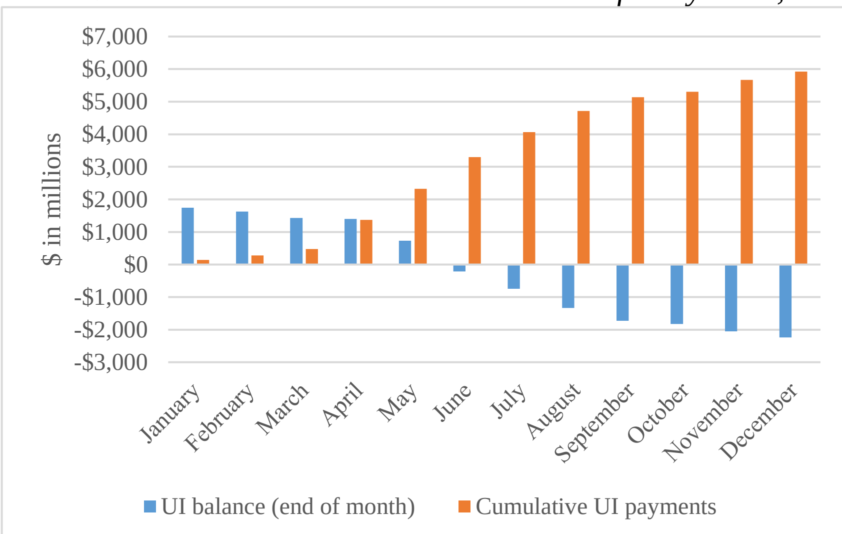
[4] US Department of Labor Directive to State Unemployment Agencies from December 30, 2020 (https://wdr.doleta.gov/directives/attach/UIPL/UIPL_9-21.pdf)

[5] US Treasury database of UI loan advances by state (https://www.treasurydirect.gov/govt/reports/tfmp/tfmp_advactivitiessched.htm)

the highest rate recorded since 1976 (16.2 percent.). The state went on to set new unemployment rate records in May and June before the rate declined in mid-summer. At the end of 2020, the state's unemployment rate was 7.4 percent.

This skyrocketing unemployment quickly depleted the state's UI trust fund. The state began 2020 with a fund balance of $1.7 billion and expected to end the year with a $1.9 billion balance. Instead, the state's trust fund had a negative balance by the end of June. As demonstrated in Chart 1, by the end of December, the state had fully expended $1.5 billion in UI taxes collected, and the state trust fund had a negative balance of $2.2 billion, representing a $3.9 billion change in position over the course of the year.

Chart 1. Massachusetts UI Trust Fund and Benefit Payments, 2020



The state's UI tax contribution schedule is determined based on the ratio of the state trust fund balance to an historical average of employer payroll. Therefore, the negative fund balance of more than $2 billion at the end of 2020 automatically triggered the highest rate of employer UI taxes – schedule G – for 2021. This means that, without legislative action, UI taxes on employers will increase to the highest allowable amount as the state's economy continues to struggle. The actual UI tax rate change for each employer will vary depending on an employer's experience rating. An employer whose experience rating has not declined over the past year faces a UI tax increase of 30 percent when the schedule moves from E to G. On average, however, the Administration estimates that employer taxes bill will grow by 60 percent (from $539 to $866), due to the impact of surging unemployment costs on experience ratings.

One purpose of automatic adjustments to the UI tax schedule is to replenish the state trust fund and, when applicable, repay the principal of federal UI loans. However, even at schedule G, state UI taxes will fall well short of the amount necessary to repay federal loans and make benefits payments, requiring other state action over the next two years. In addition, state UI taxes cannot be used to make interest payments on federal UI loans so another mechanism will be needed to repay any interest accrued in 2021. Employers face major federal tax penalties if either interest or loan repayment deadlines are not met.

<u>Baker Administration Legislation</u>

In December, the Baker Administration filed legislation designed to address these unemployment

insurance challenges. The bill was not enacted last legislative session, but has been refiled.
The Baker administration's UI bill has three basic components:

1. Freeze the state UI tax schedule at E for 2021 and 2022 to avoid an immediate UI tax increase;
2. Authorize state borrowing of up to $7 billion, secured by a further employer assessment, to replenish the state UI trust fund and repay all federal UI loans; and
3. Create a short-term employer assessment to repay all interest on federal UI loans by the relevant due dates.

First quarter UI bills are due by the end of March and so the timeline for legislative action is short.

(1) UI Rate Freeze

The Governor's bill freezes the UI rate at schedule E in 2021 and 2022.

Context: Freezing the state's UI rate schedule to limit tax increases on employers, through legislation, is not uncommon. In fact, 2020 was the first time in more than ten years that the state did not freeze, or otherwise adjust, the schedule. The logic of freezing the schedule in any year is to limit tax increases on employers; this logic is particularly compelling in 2021. Freezing at schedule E will save employers more than $500 million that can then be used to support payroll and hiring as the state economy recovers.

Freezing the UI tax schedule limits the inflow of revenues used to replenish its UI trust fund; however, the size of the deficit resulting from the unique economic circumstances of the pandemic make fund replenishment impossible with employer tax increases alone.

Recommendation: Freezing the UI schedule at E in March is vital. The freeze would save employers more than $500 million each year and does not alter the need to secure other resources to repay federal loans and cover benefit payments over the next two years.

(2) Borrowing to Repay Loans and Replenish the Fund

The Administration's legislation authorizes up to $7 billion in borrowing for the dual purpose of repaying federal UI loans in full by the November 2022 deadline and replenishing the state's trust fund for the next several years. The borrowing would be repaid through a supplemental assessment on employers.

Context: Failure to repay UI loans to the federal government by November of 2022 will result in steep tax penalties for Massachusetts employers. Further, state UI taxes alone will not be sufficient to cover benefits over the next two years.[6] Combined, these two factors create a multi-billion cash crunch for the state's UI system that needs to be addressed. The estimates presented in Figure 2 are based on current projections that are subject to change, but serve to illustrate the cash flow challenge.

[6] Estimates of state UI trust balance at Schedule E and Schedule G based on the Executive Office of Labor & Workforce Development UI Trust Fund Report from October of 2020

Figure 2. Possible UI Resources Needed, CY 2021 – CY 2025

	State Obligations	Available revenue	Resources needed
Federal loan balance	$2,212	$0	$2,212
	Estimated benefit payments	State UI revenue at E	
CY 2021	$4,821	$1,900	$2,921
CY 2022	$2,785	$1,900	$885
CY 2023	$1,567	$1,900	$0
CY 2024	$1,394	$1,900	$0
CY 2025	$1,394	$1,900	$0
Total resources needed		$6,018	

The borrowing proposed by the Baker Administration would be a special obligation bond backed by a temporary employer assessment and would not negatively impact the state's capital budget or fiscal health. The bill sets up a trust fund to receive these new employer assessments and those assessments would be dedicated to servicing the bond, which could help the bond to receive a AAA rating. The amount of the assessment and the term of repayment is not specified in the Baker legislation, but would likely be repaid over eight to ten years.

Bond proceeds would replenish the state trust fund and repay federal loans, while spreading employer costs over a longer time horizon. This approach avoids burdening current employers with the entire cost of rebuilding a trust fund decimated by a sudden economic disaster over which they had no control. Instead, the cost of rebuilding the fund would be socialized among employers over the next ten years.

There is little indication that the federal government will step in to forgive or defer state repayment of UI loans and even if that were to occur, the state would likely still need supplemental resources to cover expected levels of benefits in the coming years. Other sources of federal assistance in any upcoming stimulus could be eligible for use to subsidize the state's trust fund, but there will be many competing demands on additional federal support, and the state has never before used other budget resources to subsidize the UI trust fund.

Recommendation: Borrowing is not only the most obvious option to repay loans and create a solvent UI fund, it is likely an unavoidable option. The question then becomes, when to authorize borrowing. The state has never before bonded to repay federal UI loans, though other states have, and putting together a bond offering in the best environment and with the most favorable terms will require time and flexibility.[7] Furthermore, instituting a plan to repay the federal government and create a solvent trust fund will provide important certainty to employers, UI recipients and credit rating agencies. Authorizing borrowing now provides the time and flexibility necessary to conduct a sale that adjusts to a rapidly changing economic picture and is cost effective for the employers and the state trust fund.

[7] Massachusetts did enact legislation to authorize bonds to repay federal UI loans in 1992, but bonds were never sold (sections 51, 53 and 54 of chapter 118 of the acts of 1992).

(3) Short-term Employer Assessment

The third element of the Administration's proposal is the creation of a temporary employer assessment – separate from any assessment necessary to service the loan – to repay interest on federal loans accrued in 2021 and 2022. The proposal creates a supplemental rate, based on the existing UI rate schedule, over the next two years. Any surplus amounts generated by the assessment would be credited against employers' future state UI taxes.

Context: Approximately $40 million in federal loan interest will be owed if accrual begins on March 14th. The state cannot use UI trust fund revenue to repay interest.

For employers, a UI tax rate per schedule E plus the special assessment, as proposed by the Governor, would still be significantly less than their tax rate at schedule G. To illustrate this, Figure 3 compares the estimated tax for a mid-size restaurant with seasonal staff (experience rating between 4 and 4.5) under the Governor's bill with tax due under schedule G.

Figure 3. UI Tax Estimate Under Governor's Bill

	State UI	Interest assesment	Combined rate	Payment per employee
Gov. Baker proposal (schedule E + interest assessment)	4.170%	0.445%	4.615%	$692
Schedule G	5.380%	NA	5.380%	$807

Even with the addition of the interest assessment, the per-employee amount under schedule G is more than 15 percent higher than under schedule E. It is possible, however, that the special assessment amount could be reduced from the Governor's proposal. The Governor's assessment would generate more than $100 million annually, which likely exceeds interest charges in either 2021 or 2022.

It is also possible that federal action significantly changes Massachusetts UI interest due in 2021. President Biden and the House of Representatives have proposed delaying interest accrual until the end of August, which would make any 2021 interest owed minimal.

Recommendation: The state needs a plan to fully repay UI interest by September of 2021. That plan cannot rely on existing UI taxes and, given the uncertain time table of a bond sale, should not rely on proceeds from borrowing to repay federal loans and replenish the trust fund.

The additional assessment proposed by the Administration creates a reasonable approach for repaying the interest, particularly given that any excess assessment amounts collected would be credited against future state UI taxes. However, it is also reasonable to explore other options to repay interest depending on future federal action. The state could use available federal stimulus funds to cover any 2021 interest, thereby saving employers a cost and an additional assessment.

Bottom Line

Unemployment insurance systems around the country were upended by the speed and severity of the economic chaos brought on by COVID-19. In Massachusetts, the state has been quick to act to make adjustments to the system to respond to this unparalleled crisis. Over the past year, Legislative action has included:

- Waiving the one-week waiting period for receipt of benefits;
- Prohibiting COVID-19 related layoffs from negatively impacting employer experience ratings;
- Providing non-profits, and other self-funding employers, with additional time to repay UI costs; and
- Maximizing lost wage benefits for employees not covered by UI.

The legislature must act quickly both to freeze the 2021 UI rate schedule and put in place a plan to repay federal loans and pay-out benefits over the next several years. The timeline on the UI rate freeze is self-evident – bills are due on April 1st. The rationale for promptly implementing a borrowing plan to repay loans and replenish the state trust fund is also compelling. There is no reasonable alternative to meet the state's UI cash flow needs over the coming two years, and enacting a plan now will provide sufficient time to develop a new type of bond offering that is most advantageous to the state.

Acting on these time-sensitive issues now stabilizes the UI system in the short-term, while giving policy makers more time to consider other system improvements necessary to address the shortcomings laid bare by COVID-19.