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OFFICE OF THE LEGISLATIVE AUDITOR
STATE OF MINNESOTA

PROGRAM EVALUATION REPORT

Financing Unemployment Insurance

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OFFICE OF THE LEGISLATIVE AUDITOR
STATE OF MINNESOTA • James Nobles, Legislative Auditor

January 28, 2002

Members
Legislative Audit Commission

In May 2001, the Legislative Audit Commission (LAC) directed us to study the adequacy of the current financing system for unemployment insurance. The Commission asked for the study because of conflicting views over the adequacy of the unemployment insurance trust fund balance, which was about $700 million at the end of 2000.

We found that Minnesota's fund balance is not large compared with those in other states and with benchmarks used to assess fund adequacy. Minnesota's trust fund could easily be depleted during a mild recession like the one experienced during the early 1990s. Federal loans could be used to continue the payment of unemployment insurance benefits, but the cumulative interest costs passed on to Minnesota employers could be significant.

We recommend financing changes that would build and maintain a more adequate fund balance in the long run. In addition, we suggest certain statutory changes and administrative actions designed to lessen the cost to state employers if the fund needs to borrow during the current economic downturn.

This report was researched and written by John Yunker. We received the full cooperation of the Minnesota Department of Economic Security in the preparation of this report.

Sincerely,

/s/ James Nobles

James Nobles
Legislative Auditor

/s/ Roger Brooks

Roger Brooks
Deputy Legislative Auditor

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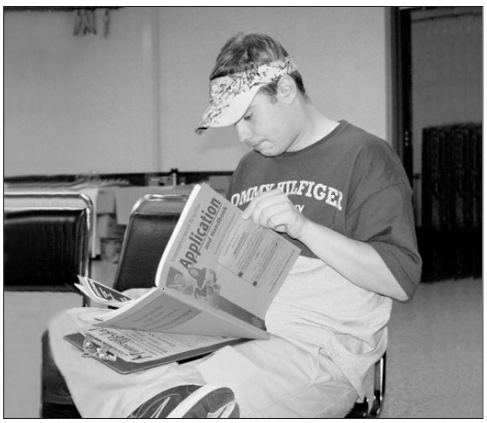

Minnesota's unemployment insurance trust fund grew during the 1990s but could be depleted during a mild recession.

- 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 (pp. 14, 17-21).
- 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 (pp. 18-19, 24-27).
- 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 (pp. 15, 30-33).
- 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" (pp. 33-35).
- 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 (pp. 38-39).

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 (pp. 40-41).
- 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 (p. 42).
- 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 (pp. 43-44).

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

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

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

Interest costs could total up to $50 million.

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, 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.

Introduction

The financing of Minnesota's unemployment insurance system has not needed significant attention since 1987. The state's strong economy and declining unemployment rates during the 1990s helped the fund recover from the debt incurred during the recessions of the mid-1970s and early 1980s. Minnesota's balance in the state's Unemployment Insurance Program Trust Fund grew from more than $400 million in debt at the end of March 1984 to a positive balance in excess of $700 million at the end of December 2000.

The state's apparently "large" balance in the trust fund attracted the attention of legislators during the 2001 legislative session. Some were interested in using part of the fund balance to provide parental leave benefits to new parents, while others wanted to extend the duration of unemployment insurance benefits for individuals affected by the closing of certain businesses. Other legislators and policy makers, however, expressed concern about using the fund balances for these purposes. They suggested that the trust fund balance, while large in absolute terms, was not large relative to the number of workers covered by the system or the potential drawdown of the fund during a recession. They believed Minnesota was running a significant risk of needing to borrow from the federal government in the event of a recession. Borrowing would cause employers to pay the additional costs of interest on the loans and might force the state to raise taxes during a recession.

As a result, in May 2001, the Legislative Audit Commission (LAC) directed our office to examine the adequacy of the current fund balance and the system for financing unemployment insurance benefits. Most of the work on this project was delayed until October 2001 so that research on other projects authorized by the LAC could be completed in a timely manner. This report addresses the following questions:

- **What has been Minnesota's experience with financing unemployment insurance benefits?**

- **How does Minnesota's unemployment insurance system—including its trust fund balance and its benefit and tax levels—compare with those in other states?**

- **What benchmarks have been suggested for state fund balances, and how does the size of Minnesota's fund balance compare with suggested standards? What evidence is there that meeting fund balance benchmarks reduces the likelihood that a state will need to borrow from the federal government?**

- **How likely is it that Minnesota will need to borrow from the federal government in the near future? How deep would a recession have to be to cause the state to have a negative fund balance? How well do the existing features of Minnesota law work to prevent the need for borrowing?**

- **What are the advantages and disadvantages of Minnesota's current financing system? Should the state maintain a larger balance in its unemployment insurance fund? What alternatives would help the state maintain a larger fund balance?**

In conducting this study, we used four primary sources of information. First, we reviewed available data and information on the 50 state unemployment insurance systems. Information from the federal government and other sources was used to make comparisons of state systems. Second, we reviewed national literature for a variety of purposes. These studies and reports helped us identify benchmarks used for state fund balances and examine the evidence that meeting these standards would reduce the likelihood that a state would need to borrow from the federal government. Available studies also helped identify policy options and the primary advantages and disadvantages of various options.

Third, we interviewed state officials in the Minnesota Department of Economic Security to gain a detailed understanding of the workings of Minnesota's unemployment insurance system. Interviews with state government officials and others also helped identify policy options and the views of various stakeholders on those options. Finally, using data on Minnesota's unemployment insurance system, we constructed a model to estimate future benefits, taxes, and fund balances. We used the model to provide insights into the ability of Minnesota's financing system to build and maintain an adequate fund balance.

Chapter 1 of this report discusses how Minnesota's unemployment insurance system currently works and presents information on Minnesota's experience in financing unemployment benefits over the last 30 years. It also compares the state's benefits, tax rates, and fund balance with other states. Chapter 2 measures the adequacy of Minnesota's fund balance using national benchmarks and examines the ability of the state's unemployment insurance financing system to avoid future borrowing. Chapter 3 discusses the advantages and disadvantages of potential changes to the state's financing system and presents recommendations for legislative and agency consideration.

1 Background

SUMMARY

Minnesota has enjoyed lower than average unemployment insurance tax rates, higher than average benefits, and a growing fund balance since the recession of the early 1990s. These advantages have largely been the result of unemployment rates that have steadily declined and reached a low in 1999 that had not been experienced since World War II. Minnesota's unemployment insurance fund balance, however, is not large compared with other states and has declined during 2001 as unemployment rates increased.

Established by the Social Security Act of 1935, unemployment insurance has been a prominent social program in the United States for many years. The main purpose of the program is to provide temporary financial assistance to eligible workers who become unemployed through no fault of their own.[1] The benefits paid to the unemployed partially replace their loss of income and help to maintain their standard of living. By adding to consumer purchasing power during recessions, unemployment insurance benefits help to stabilize the nation's economy and prevent an even further worsening of economic conditions. Federal requirements concerning the financing of the unemployment system may also help to stabilize employment. States must implement tax systems that rely, in part, on an experience rating of private employers. When employers must pay taxes based on past layoff experience, they may have financial incentives to reduce the number of layoffs.[2]

The 50 states—as well as the District of Columbia, Puerto Rico, and the Virgin Islands—play a significant role in the unemployment insurance system. Each state establishes its own laws regarding unemployment insurance benefits and taxes and administers its own unemployment insurance system by paying benefits and collecting taxes and reimbursements. In Minnesota, the Department of Economic Security is responsible for administering the state's unemployment insurance system.[3]

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1 In June 2000, the United States Department of Labor also permitted state unemployment insurance programs to provide parental leave benefits. These benefits may be provided to parents of newborn or newly adopted children who are on an approved leave or choose to leave employment. Thus far, no state has used the unemployment insurance program to provide parental leave benefits.

2 Wayne Vroman, *Topics in Unemployment Insurance Financing* (Kalamazoo, Michigan: W. E. Upjohn Institute for Employment Research, 1998).

3 The 2001 Legislature passed a state agency reorganization and restructuring bill that would eliminate the Department of Economic Security by July 1, 2002. The 2002 Legislature is expected to determine which state agencies will assume the department's duties.

Both state and federal laws govern the operation of the unemployment insurance system.

The federal government also plays a major role. The United States Department of Labor must approve state unemployment insurance systems, and there are significant financial penalties for non-compliant states. In return, the federal government provides funding for administration of state unemployment insurance systems. In addition, the federal government provides loans to states that have depleted their account balance in the federal Unemployment Trust Fund.

In this chapter, we provide information about Minnesota's unemployment insurance system and compare Minnesota's system with those in other states. Specifically, we address the following questions:

- **How does Minnesota's unemployment insurance system work? Why is there a need for a fund balance?**
- **What has been the state's experience with financing unemployment insurance benefits?**
- **How do Minnesota's unemployment insurance benefits, taxes, and fund balance compare with those in other states?**

MINNESOTA'S SYSTEM

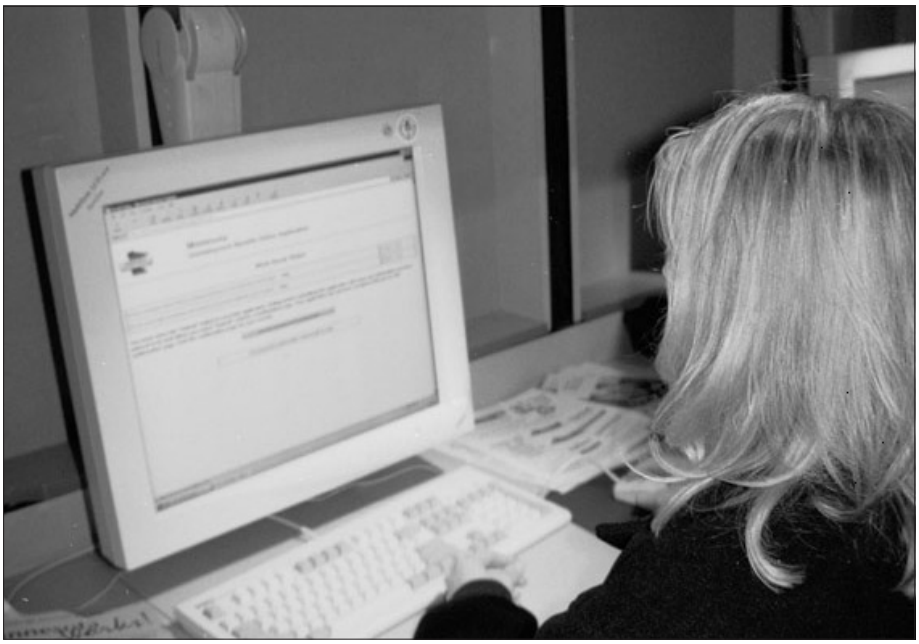
In this section, we examine the key aspects of the financing system for unemployment insurance in Minnesota. In particular, we are interested in how an individual's benefits and an employer's taxes are calculated. We are also concerned with how total benefits paid and total taxes received fluctuate throughout the year and how they change from year to year as economic conditions change.[4]

It should be noted that unemployment insurance differs from some other benefit programs operated by the state. Unemployment insurance benefits are paid by the state from a special fund that can only be used for this purpose. The fund obtains its money from employers who pay a specific tax designated for unemployment insurance. The funding system is different from the workers' compensation system in which an employee receives payments directly from an employer through the employer's insurance company.

Benefits

To be eligible for unemployment insurance benefits in Minnesota, an unemployed individual must have had at least a minimum amount of earnings during a base period. The base period is one year long and ends several months prior to the date the individual applies for benefits. An individual is eligible for benefits if he or

4 Those interested in more information on the employees and employers covered by unemployment insurance in Minnesota or on the eligibility of individuals for unemployment benefits should consult one of the publications from the Minnesota House Research Department. See House Research Department, *Unemployment Insurance: A Guide*, (November 2000); http://www.house.leg.state.mn.us/hrd/issinfo/unempins.htm; accessed June 6, 2001; or Linda Holmes, House Research Department, *Reemployment Insurance* (St. Paul: House Research Department, November 1998).



Unemployed workers can apply for unemployment insurance benefits on the internet, by phone, or using paper forms.

she has earned at least $1,000 in one quarter of the base year and at least $250 during the remainder of the base year.

Amount of Benefits

Benefit levels are tied to a person's past wages.

An individual's weekly benefit amount is based on a percentage of his or her past earnings up to a maximum. Specifically, an individual's weekly benefit is the greater of two amounts: 1) 50 percent of the applicant's average weekly wage during the base period, up to a maximum of two-thirds of the state's average weekly wage; or 2) 50 percent of the applicant's average weekly wage during the high quarter, up to a maximum of 50 percent of the state's average weekly wage. The maximums computed using the state's average weekly wage apply for a 12-month period beginning August 1st. The state's average weekly wage is calculated on or before June 30th for the previous calendar year.

The maximum weekly benefit amount under clause #1 above for the 12-month period beginning August 1, 2001 is $452. That maximum is based on a statewide average weekly wage for 2000 of $679. The maximum under clause #2 is $339, which is 50 percent of the state's average weekly wage.[5]

For our purposes, it is important to note that total benefit payments paid by the state will vary from year to year based on three factors: the state's unemployment rate, average wages, and total employment. The state's unemployment rate is the most important factor in determining the amount of benefits payments made during a year. If the unemployment rate is twice as high as a year ago, then benefit payments will be about double last year's payment, absent changes in other important factors.

5 By law, the weekly benefit amount, as well as the maximums computed using the state's average weekly wage, are rounded down to the next lowest whole dollar.

Most people are familiar with the state's total unemployment rate, but the relevant rate for benefit purposes is the "compensable unemployment rate." This monthly statistic divides the number of people actually receiving unemployment benefits—measured by the number of weeks of benefits paid during the week including the 19th of the month – by the state's total employment, excluding federal employees. The total unemployment rate statistic usually quoted in the media is based on information obtained in surveys. It divides the number of individuals who say they are unemployed by the number of individuals who say they are working or looking for work. The compensable unemployment rate is typically lower than the total unemployment rate because only about 40 percent of the unemployed receive unemployment benefits. Many of those not receiving benefits may be new entrants to the labor force or may have voluntarily quit their last job and thus may be ineligible for benefits.

Another important factor is average weekly wages. As we saw above, benefit payments are indexed for inflation in wages. An individual's benefits depend on his average weekly wage prior to being unemployed and the maximum benefit available depends on the state's average weekly wage. As wages increase over time, total benefit payments from the state's Unemployment Insurance Fund tend to increase without a change in state law.

Finally, employment levels play a role in the amount of total benefits paid during a one-year period. Given a constant unemployment rate, growth in employment results in more people filing for unemployment benefits and thus growth in the total benefits paid from the state's fund.

Length of Benefits

Typically, an applicant is limited to a maximum amount of benefits equal to one-third of base period wages or 26 weeks of benefits at the calculated weekly benefit amount, whichever is less. The average duration of benefits in recent years has been about 14 weeks. During recessions, the average duration tends to increase but not by very much. In 1982-83, for example, the average duration was about 17 weeks.

Unemployed individuals who have exhausted their regular benefits may be eligible for additional benefits. State law provides additional benefits to workers laid off at facilities that had at least 100 employees, laid off at least 50 percent of them in a one-month period, and had no plan to resume operations and rehire the employees. To be eligible, the facility must be located in a county that had a seasonally adjusted total unemployment rate of 10 percent or more during the three months before the layoff or the three months after the layoff. Eligible individuals may receive additional benefits of up to one-half of the regular benefits they received.

On occasion, the Legislature has passed special legislation to provide additional benefits for laid-off workers who would not otherwise qualify under mass layoff or high unemployment rate provisions of the statute. The additional benefits paid based on either the state statute or special legislation have not been large relative to the amount of regular benefits paid. From 1994 through 2000, the state paid

additional benefits totaling about $0.8 million, while total benefits paid during this period were between $340 and $400 million annually.

The federal government also has an extended benefits program that pays additional benefits of up to 13 weeks to individuals who have exhausted their regular benefits. A state is required to pay half of the program costs incurred by its residents.[6] The program only pays benefits if the state has a fairly high unemployment rate. Federal extended benefits have not been paid in Minnesota since the 1980s.

Employer taxes and reimbursements finance the payment of benefits.

Taxes

Unemployment insurance benefits are financed through employer taxes or reimbursements paid to the state's Unemployment Insurance Program Trust Fund. Most employers pay taxes, except public employers and nonprofit organizations, which may instead reimburse the fund directly for the benefits their employees received.

Tax Base

Taxes are calculated by applying an employer's tax rate to the employer's taxable wages. Taxable wages in 2002 are the first $21,000 of an employee's wages. Like benefits, the amount of wages that are taxable is indexed for growth in the state's average wages. The taxable wage base is equal to 60 percent of the state's average annual wage in covered employment and is rounded to the nearest $1,000.[7]

Experience Tax Rate

An employer's tax rate is the sum of two tax rates: an experience tax rate applied only to that employer and a base tax rate applied to all employers in the state. An employer's experience tax rate equals 125 percent of the benefits charged to an employer's account during a past period of time divided by the employer's taxable wages for the same period. The experience tax rate for each employer is rounded to the nearest 0.1 percent and cannot exceed 8.9 percent.

An employer's tax rate is based in part on the experience of its employees in collecting benefits.

The period of time used to calculate the rate is between 12 and 60 months and depends on how long the employer has been covered by the unemployment insurance system. The period includes the 12-month to 60-month period ending on the June 30th prior to the year for which taxes are being calculated. Thus, the experience tax rate in 2001 for a long-time employer in Minnesota is based on the employer's experience from July 1, 1995 through June 30, 2000. If an employer does not have at least 12 months of experience in the system, then the employer is assigned an experience rate similar to that assigned by law to new employers.

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6 See *Minn. Stat.* (2000), §268.115 for the conditions under which federal extended benefits are paid.

7 There is a lag between the growth in wages and increases in the taxable wage base. For example, the taxable wage base of $21,000 in 2002 was calculated using the average annual wage for 2000.

Tax collections from the experience tax do not capture all of the benefits paid to workers laid off by experience-rated employers. First, state law does not permit certain benefits to be charged to employers.[8] Second, some employers go out of business in Minnesota and thus cannot be taxed to recover benefits paid to their previous employees. Finally, the cap on the experience tax rate results in some benefits never being recovered through experience rating.

Base Tax Rate

Because the experience tax does not recover all the costs of all benefit payments, these costs to the system must be recovered through some other means. The primary way in which these costs are recovered is through the base tax applied to all tax-paying employers. The base tax rate in a particular year depends on the fund's balance on June 30th of the previous year, not including any loans from the federal government. Table 1.1 shows the base rate schedule that was in effect from 1991 through 2001. Under this schedule, a fund balance of $300 million or more results in a base tax rate of 0.1 percent, while a balance of less than $200 million results in a 0.6 percent rate.

An employer's tax rate is also based on the trust fund balance.

Table 1.1: Base Tax Rate Schedule

Unemployment Insurance Fund Balance on Previous June 30th	Base Tax Rate for the Current Year	Portion Deposited in the Trust Fund, 2002-05	Portion Designated for the UI Technology Initiative, 2002-05[a]
Less Than $200 million	0.6%	0.58%	0.02%
Between $200 and $225 million	0.5	0.48	0.02
Between $225 and $250 million	0.4	0.38	0.02
Between $250 and $275 million	0.3	0.28	0.02
Between $275 and $300 million	0.2	0.18	0.02
$300 million or more	0.1	0.08	0.02

[a]The amount of money that will be raised for the technology initiative is capped at $30 million.

SOURCE: *Minn. Stat.* (2000), §268.051, subd. 2(b).

As a result of legislation passed during the special legislative session in June 2001, the portion of the base tax rate going to the unemployment insurance fund will be less than indicated on the schedule from 2002 through 2005. During these four years, a portion of the base tax rate—subject to a maximum collection over the period of $30 million—will be used to upgrade unemployment insurance computer systems and will not be available for the payment of unemployment benefits. The amount of the reduction will be 0.02 percentage points. For 2002, for example, one-fifth of the base rate revenue will be used for technology upgrading. The trust fund will receive revenues based on a tax rate of 0.08 percent and the technology initiative will receive revenues based on a 0.02 percent

8 For example, benefits paid to an employee who quits one job and is laid off from a subsequent job cannot be charged to the first employer even though part of the employee's benefits may be based on earnings from the first job. For a complete list of noncharge provisions, including those applicable to reimbursable as well as taxable employers, see *Minn. Stat.* (2000), §268.047.

rate. If the fund balance falls below $300 million in subsequent years, the technology initiative will continue to receive revenues based on a 0.02 percent tax rate. The trust fund will receive the difference between the rate on the schedule and the 0.02 percent that is being set aside for the technology initiative.

It has been suggested that the 25 percent surcharge added to an employer's past benefits in the calculation of the experience rate is another way of recouping the costs that cannot be directly charged to employers. Others, however, suggest that the surcharge does not recover these costs but is instead a way of charging employers for the delay with which benefits are repaid. There is a delay between 10 months and 6 years plus 7 months between the time benefits are paid and the time they are recovered.[9] All or part of the 25 percent surcharge may reflect interest on benefits paid but not recovered until years later.

Reimbursements from public and nonprofit employers also fail to fully pay for benefits used by their employees. As with private employers, state law does not permit some benefits to be charged to reimbursing employers. In addition, nonprofit organizations sometimes go out of business although less frequently than private businesses. Unemployment benefits paid to the employees of defunct organizations are not recovered by the fund. There is also a short delay in the repayment of benefits by public and nonprofit employers.[10] Even though there are some benefit costs not recovered from public and nonprofit employers, the amount of money is relatively small and has not had a significant effect on the financial health of the unemployment insurance system.

Solvency Tax

A solvency tax is activated when the fund balance is low.

Minnesota also has a solvency tax, which is activated for a calendar year only if the fund balance was less than $150 million on June 30th of the previous year. The solvency tax is applied as a 10 percent surcharge to the tax bills of all tax-paying employers. The main purpose of the solvency tax is to pay any interest owed on funds the state has borrowed from the federal government for the purpose of paying unemployment benefits. Federal law does not permit states to pay interest directly or indirectly from their account in the federal Unemployment Trust Fund. The solvency tax is a legally acceptable way to pay for the interest and can be used to pay unemployment benefits if not needed for interest payments.

Fund Balances

Minnesota's Unemployment Insurance Program Trust Fund consists of three accounts: a clearing account, a benefit payment account, and the state's account in the federal Unemployment Trust Fund. Taxes and reimbursements are first

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9 The amount of delay reflects the 60-month experience period, the six-month gap between the experience period and the tax year, and the timing of the quarterly payments for a tax year. Taxes assessed during a particular year are payable by the last day of the month following each quarter of the year. For example, payments for 2001 are due by April 30, July 31, and October 31 of 2001 and January 31, 2002.

10 The delay in benefit repayment by reimbursing employers is generally less than that for taxable employers. Reimbursing employers must pay chargeable benefits back to the fund each quarter. The payments for each quarter are due at the end of the month following the month in which bills are sent to reimbursing employers.

deposited in the clearing account. After checks clear, the Department of Economic Security (MDES) transfers money from the clearing account to Minnesota's account in the federal Unemployment Trust Fund. When money is needed to pay benefits, MDES employees transfer money from the trust fund account to the benefit payment account.[11]

Interest Earnings

The bulk of the money in the state fund is in the trust fund account, where it earns interest quarterly based on the federal government's investment earnings for the entire federal Unemployment Trust Fund. The interest rate paid to states has been between about 6.4 and 6.6 percent per year over the last two years ending on September 30, 2001. Monies in the clearing account maintained by a local bank generally earn less interest. In September 2001, the interest rate earned on the clearing account was about 3.4 percent. Interest earnings in the clearing account are used to offset fees paid to the bank for collecting and processing the checks received from employers. Monies are retained in the clearing account longer than is necessary in order to accumulate enough interest to pay for the bank fees. This practice results in a loss of interest to the state's trust fund because the federal government pays a higher interest rate than the bank. MDES has to forego the additional interest, however, because the agency has no other way to pay the fees. The federal government does not permit a state to pay these bank fees out of money belonging to the state's account in the federal trust fund.

Loans

Loans are available from the federal government if the state trust fund is depleted.

If a state lacks sufficient funds to pay benefits, the federal government will lend the state money for that purpose. Loans made on or after April 1, 1982 have required the payment of interest to the federal government. The interest rate charged states during a particular year is equal to the annual rate of interest earned by the federal Unemployment Trust Fund during the fourth quarter of the previous year. The interest rate is, however, capped at 10 percent. The interest rate applicable to federal loans outstanding during 2002 is 6.3 percent.

Under some limited circumstances, the federal government will make interest-free cash flow loans to states. A state may avoid paying interest on a loan if it is able to pay the loan back before September 30th of the year in which the loan was made. If the state, however, needs to borrow additional funds before the end of the calendar year, then interest will be charged.

The federal government discourages excessive borrowing both through interest charges and the imposition of additional federal taxes to pay off loans. In order to fund federal unemployment insurance costs and obligations, the federal government currently imposes a federal tax of 0.8 percent on the first $7,000 of an employee's wages.[12] If a state has an outstanding loan balance on January 1st of two consecutive years and fails to fully repay its loan by November 10th of the

11 The federal government also places monies for the administration of a state's unemployment insurance program in the state's account in the federal trust fund. A state may withdraw these funds from the trust fund account to pay administrative expenses.

12 Certain employers such as government agencies and charitable organizations are not required to pay the federal unemployment tax.

second year, the federal tax is increased by 0.3 percent and the proceeds are used to help pay off the loan. The tax can be increased by as much as an additional 0.3 percent in each subsequent year until the loan is paid off. The imposition of such a tax on all private employers in a state regardless of their layoff history is generally not popular with states. They usually prefer to impose more of the costs of paying off their loans on employers that had significant layoffs.[13]

Rationale for a Fund Balance

A large fund balance helps the state respond to a sudden jump in unemployment rates without borrowing from the federal government.

A state needs to maintain a fund balance in order to make benefit payments. Payments are made each week while taxes are collected quarterly. Without an adequate fund balance, a state would frequently need to borrow from the federal government. Frequent borrowing would result in additional interest costs and the imposition of higher federal taxes on employers.

The main reason a state needs a fund balance is that unemployment rates may increase suddenly and dramatically. If an adequate fund balance is not available, borrowing must be used to finance the payment of benefits during a recession and interest must be paid on any loans. Failure to maintain an adequate fund balance would also probably result in higher employer taxes during a recession unless the recession is very short. Experts believe the national economy is more stable if states build and maintain an adequate fund balance during strong economic conditions rather than increase taxes during a recession.

States also experience quarterly fluctuations in their fund balances for which they need to plan. In the first quarter of the calendar year, Minnesota typically pays out about 41 percent of its benefits and collects only about 13 percent of its taxes. This occurs because taxes received during the first quarter are based on taxes assessed during the fourth quarter of the previous year. Fourth quarter assessments are relatively low because many firms have already reached the maximum tax base for most of their employees.

HISTORICAL TRENDS

Unemployment Rates

Over the last 30 years, Minnesota has faced three recessions. The first of these recessions occurred in 1974-75 and followed a large increase in oil prices. Unemployment rates were relatively high in Minnesota during 1975 and 1976. The second recession took place in 1982-83 but included fairly high unemployment rates from 1980 through 1983. This recession occurred following another large increase in oil prices in 1979 and was partially due to the presence of double-digit interest rates. The recession in 1991-92 was relatively mild in Minnesota, although it was more severe in certain other states.

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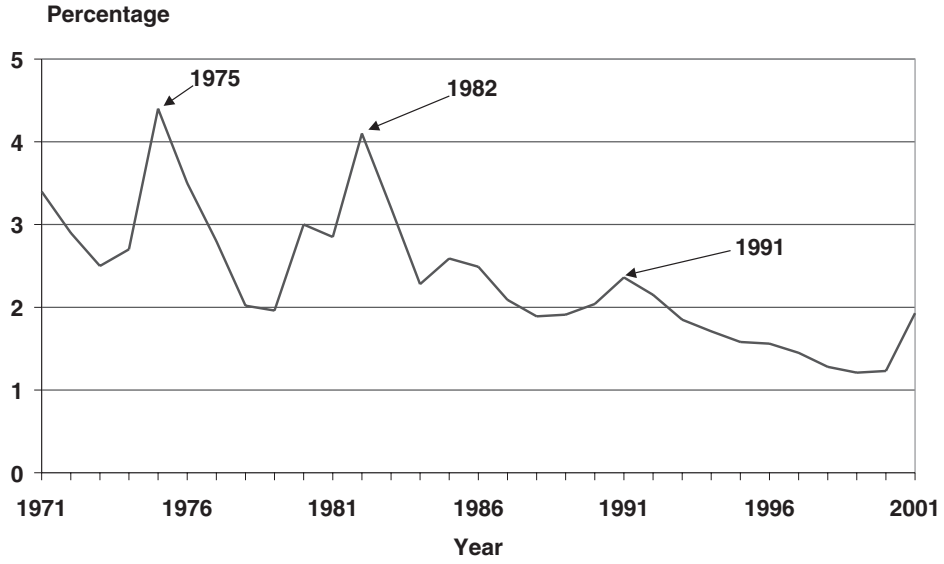
13 Technically, the federal unemployment tax is 6.2 percent. A state, however, receives a 5.4 percent credit offset and its employers pay a tax of 0.8 percent, if the state meets the federal requirements for unemployment insurance programs. If a state fails to repay its loans, the tax is increased by gradual reductions in the credit offset.

Minnesota's experience with unemployment rates is depicted in Figures 1.1 and 1.2. The first figure shows the severity of the recessions during the 1970s and 1980s as well as the modest nature of the recession during the early 1990s. It is also clear that unemployment rates during the rest of the 1990s were lower than at any time during the last 30 years. The rate during 1999 was lower than during any year since World War II.[14]

Unemployment rates generally declined during the 1990s.

Figure 1.1: Minnesota's Insured Unemployment Rate, 1971-2001



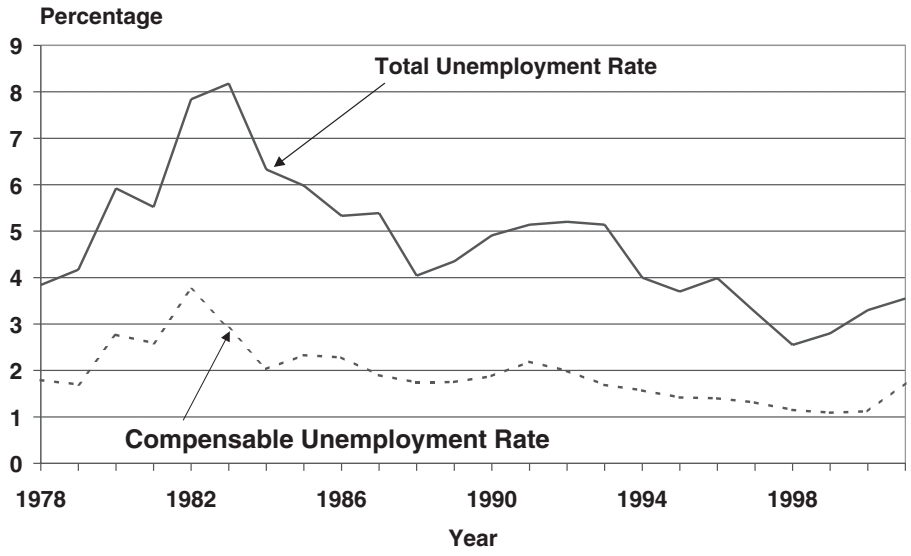
Source: Minnesota Department of Economic Security and U.S. Department of Labor, ET Handbook No. 394.

Figure 1.2 compares trends in Minnesota's total unemployment rate with trends in its compensable unemployment rate. As discussed earlier, the compensable unemployment rate measures the number of people receiving unemployment benefits as a percentage of employment. This figure shows that the percentage of workers receiving unemployment benefits steadily declined in Minnesota following the 1991-92 recession. Minnesota's compensable unemployment rate, which was 3.8 percent in 1982 and 2.2 percent in 1992, was only 1.1 percent in 1999 and 2000. The long period of sustained economic growth and low unemployment rates since 1992 may be over. Compensable unemployment rates in Minnesota and the nation increased significantly during 2001. Economic experts believe the nation entered a recession during the spring of 2001.

The figure also shows that a substantial share of the unemployed do not receive unemployment benefits. Some of those not receiving benefits are ineligible for benefits because they only recently entered the labor force or they voluntarily quit

14 The insured unemployment rate measures the number of people requesting unemployment insurance benefits as a percentage of average monthly employment. This rate is slightly higher than the compensable unemployment rate for all employers except federal employers, since some employees requesting benefits are not eligible to receive them. The insured unemployment rate was used in Figure 1.1 because data on other types of unemployment rates were not readily available for years prior to 1978.

Figure 1.2: Minnesota's Total and Compensable Unemployment Rates, 1978-2001



Source: Minnesota Department of Economic Security.

their job. Others do not apply for benefits because they expect to obtain a new job within a short period of time. Generally, only about 40 to 50 percent of the unemployed receive unemployment benefits.

Fund Balances

Minnesota's trust fund borrowed from the federal government during the 1970s and 1980s.

The balance in Minnesota's Unemployment Insurance Program Trust Fund has declined and increased over the last 30 years largely in response to economic conditions. The fund entered the 1970s with a balance of about $120 million, or about 1.9 percent of total wages covered by unemployment insurance. The recession of the mid-1970s caused the fund to be depleted by July 1975. In order to pay benefits, Minnesota borrowed a total of $172 million from the federal government in the years 1975 through 1977. As higher taxes were implemented and the economy improved, Minnesota was able to repay the federal loans. Minnesota's fund was once again "in the black" by May 1979. Fortunately for Minnesota and other states, federal loans during the 1970s were interest-free. By repaying its debt, Minnesota also avoided any increase in federal unemployment taxes.

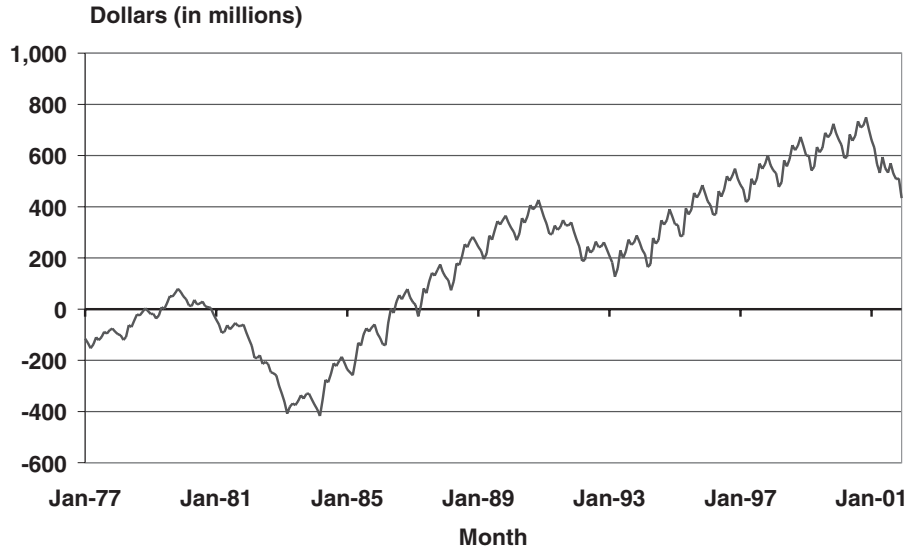
The trust fund did not remain debt-free for very long. The worsening economy of 1980 caused the trust fund to borrow again from the federal government. The length and depth of the recession during the early 1980s, as well as the small balance with which Minnesota entered the 1980s, caused the fund to remain in debt to the federal government for more than six years. Minnesota's loan from the federal government, which was more than $400 million at times, was repaid in full in 1987.

This experience with borrowing was much more costly than the experience in the 1970s. The federal government charged interest on loans made after April 1, 1982. Much of the interest paid by Minnesota in the 1980s was at a 10 percent interest rate. The federal government also implemented increases in the federal unemployment tax for the purpose of repaying Minnesota's debt. The federal government increased its tax on Minnesota employers by 0.3 percentage points in 1983 over the usual rate. The rates in 1984, 1985, and 1986 were 0.6, 0.8, and 1.1 percentage points higher than the usual rate.

The improving economy and tax changes made by the 1987 Legislature helped the trust fund balance to grow during the rest of the 1980s. As Figure 1.3 shows, the fund grew from a deficit of $417 million at the end of March 1984 to a positive balance of $427 million at the end of November 1990. The balance at the end of 1990 was about 1.1 percent of total covered wages.

The trust fund has not needed to borrow since early 1987.

Figure 1.3: Unemployment Insurance Fund Balance, January 1977 - December 2001



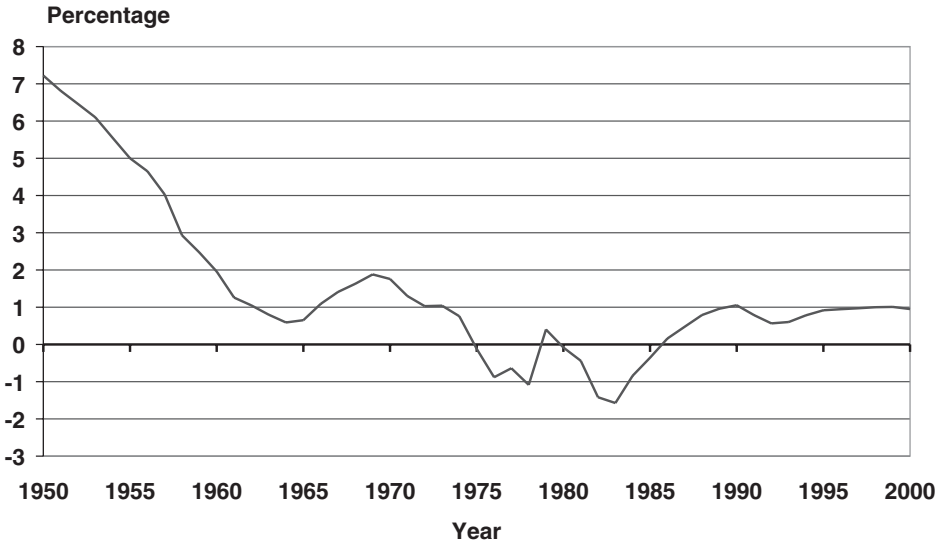
Source: Minnesota Department of Economic Security.

The fund balance, however, began to decline during 1991 due to increasing unemployment rates. The balance declined to $127 million at the end of March 1993 but was not depleted as a result of the 1991-92 recession. There were two reasons for the fund's good fortune. First, the recession of the early 1990s was relatively mild. Minnesota's compensable unemployment rate was only 2.2 percent in 1991 and 2.0 percent in 1992 compared with rates of 3.8 percent in 1982 and 2.9 percent in 1983. Second, although the fund balance entering the recession was not large, it benefited from legislative decisions made in 1987. The 1987 Legislature modified the base tax rate schedule but retained base rates for 1988-90 higher than would have generally been in place using either the old or new schedules. The base tax rates adopted for those three years raised sufficient revenue to keep the fund from borrowing in 1993. We estimate that the rates

raised an excess of $250 million more than would have been raised during 1988-90 using the old base rate schedule.

Following the low point reached in March 1993, the trust fund balance grew as unemployment rates declined. At the end of 2000, the fund balance was $702 million, or about 0.9 percent of wages covered by the unemployment insurance system. In other words, the fund balance—while larger in dollars than ever before—was actually a little lower as a percentage of covered wages than it was just prior to the 1991-92 recession. Figure 1.4 shows how Minnesota's fund balance as a percentage of covered wages has changed over the years. This percentage is more commonly known as the fund's "reserve ratio." The figure indicates that the reserve ratio was generally higher prior to the 1974-75 recession than it has been since then.

Figure 1.4: Reserve Ratio, 1950-2000



Source: Minnesota Department of Economic Security and U.S. Department of Labor, ET Handbook No. 394.

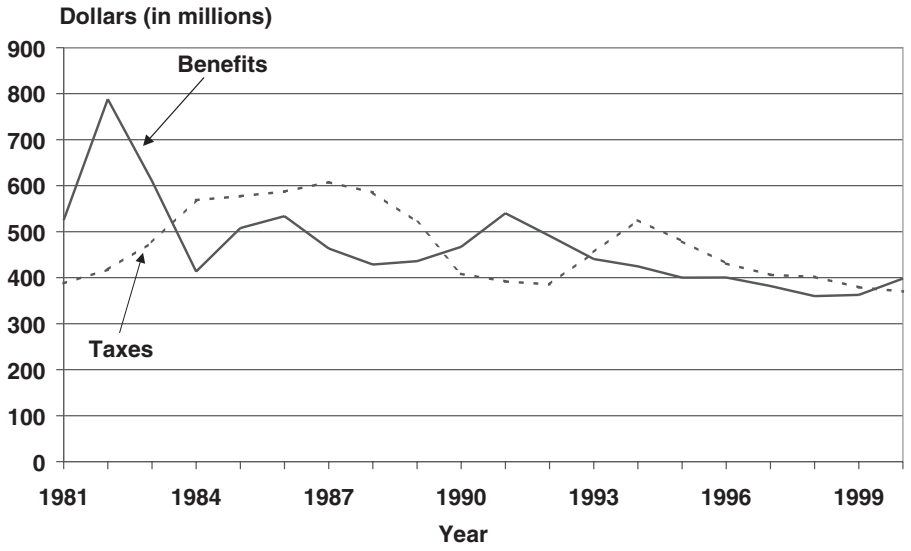
The current recession may deplete the fund by late 2002 or early 2003.

As mentioned earlier, unemployment rates increased significantly during 2001. This increase has had a detrimental effect on the trust fund. As of the end of December 2001, the fund balance was $434 million, or almost $270 million lower than it was a year earlier. Analysts from the Minnesota Department of Economic Security suggest that the fund might need to borrow from the federal government by late 2002 or early 2003 unless the unemployment situation improves.

Benefits and Taxes

Over the last 20 years, the amount of unemployment insurance benefits paid in Minnesota has varied in response to changes in unemployment rates and other factors. As Figure 1.5 suggests, unemployment rates have the largest influence on

Figure 1.5: Benefits and Taxes in 2000 Dollars, 1981-2000



SOURCE: Office of the Legislative Auditor's analysis of data from the Minnesota Department of Economic Security and the Bureau of Labor Statistics.

Declining unemployment rates have caused benefit payments and taxes to fall during much of the 1990s.

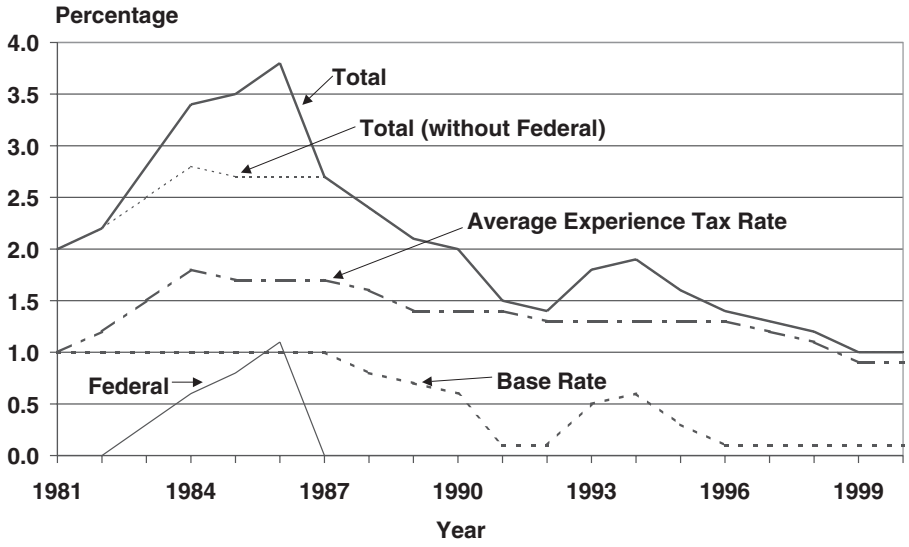
benefit payments. From 1995 through 2000, benefit payments were $400 million or less in inflation-adjusted dollars. In contrast, the state paid higher benefits during the recessions of the early 1980s and the early 1990s. Benefit payments in 1982 were almost twice as high as in 2000. Payments in 1991 were about one-third higher than in 2000.

Unemployment rates are not, however, the only economic factor affecting benefit payments. Between 1981 and 2000, inflation-adjusted payments fell only 26 percent even though the compensable unemployment rate in 2000 was less than half the 1981 rate. Employment growth of 54 percent and an inflation-adjusted increase in the average weekly benefit amount of 17 percent partially offset the reduction in benefits caused by a lower unemployment rate. The growth in the average weekly benefit amount was closely tied to growth in the average weekly wage, which rose 24 percent over this period. Much of the growth in inflation-adjusted average wages and the average weekly benefit amount occurred during the 1990s.

Figure 1.5 also shows that annual tax collections, including reimbursements from public and non-profit employers, were the highest in the years following the 1980-83 recession. Inflation-adjusted tax collections declined from 1987 to 1992 but increased in 1993 and 1994 as tax rates rose in response to the higher unemployment rates during the 1991-92 recession and the resulting lower fund balance. Since 1994, collections have generally declined as unemployment rates dropped and the trust fund balance grew.

To some extent, the changes in tax collections reflect changes in tax rates charged to Minnesota employers. As Figure 1.6 shows, the average tax rate increased

Figure 1.6: Average Unemployment Insurance Tax Rates, 1981-2000



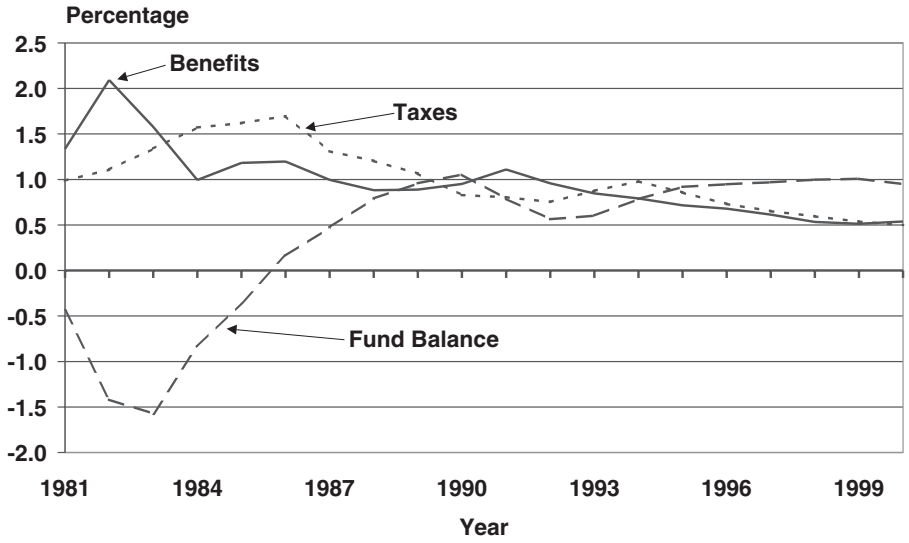
SOURCE: Minnesota Department of Economic Security.

from 2.0 percent of taxable wages in 1981 to 3.8 percent in 1986. The increase was due to growth in the average experience tax rate and the additional federal taxes being levied on Minnesota employers. The experience tax rate grew in response to the higher unemployment benefits paid during the 1980-83 recession while the additional federal taxes were required to repay the state's loan from the federal government. The average tax rate on taxable wages has fallen significantly since 1986, although it increased in 1993 and 1994 when the 1991-92 recession caused experience tax rates to increase. The base tax rate also increased as a result of a lower fund balance.

In 2000, the average tax rate was only 1.0 percent of taxable wages in 2000 or only half the average rate in 1981. Inflation-adjusted tax collections in 2000 were, however, only 5 percent lower than in 1981. Increases in taxable wages because of growth in employment and average wages have offset much of the decline in tax rates.

Figure 1.7 illustrates the variation in benefits, taxes, and fund balances as a percentage of total wages covered by the unemployment insurance system. During recessions, benefits have generally exceeded taxes as a percentage of wages and consequently fund balances have fallen. Following recessions, taxes have exceeded benefit payments with a resulting growth in the fund balance as a percentage of wages. Since 1996, annual taxes and benefits have been about equal and there has been little change in the fund balance as a percentage of covered wages.

Figure 1.7: Benefits, Taxes, and Fund Balances as a Percentage of Covered Wages, 1981-2000



Source: Office of the Legislative Auditor's analysis of data from the Minnesota Department of Economic Security.

COMPARISONS WITH OTHER STATES

In this section, we examine how Minnesota's unemployment insurance program compares with other states. In order to make fair comparisons among states, we calculated benefit payments, taxes, and fund balances as a percentage of total wages covered by unemployment insurance systems in Minnesota and other states. Using this method, we found a clear difference between Minnesota's fund balance and the national average. Figure 1.8 shows that:

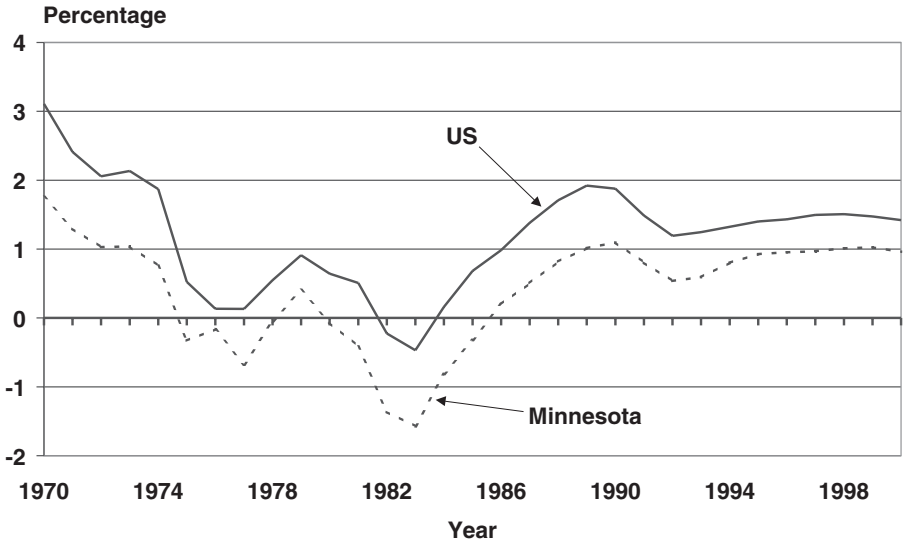
- **Minnesota's fund balance as a proportion of wages—its reserve ratio—has been consistently below the national average over the last 30 years.**

Since 1988, Minnesota's year-end reserve ratio has been between 30 and 55 percent lower than the national average. As of the end of June 2001, fund balances nationally were about 1.41 percent of total wages, while Minnesota's fund balance was about 0.73 percent of total wages, or about 48 percent below the national average. While Minnesota's balance was the 30th largest among the 50 states in dollars, Minnesota's reserve ratio was the 45th largest. Only five other states had reserve ratios lower than the ratio for Minnesota.

In general, we found no consistent pattern in how Minnesota's benefit payments and taxes differed from national averages over the last 30 years. During most of the 1980s, benefit payments as a percentage of total wages were higher than average in Minnesota, but they were lower than the national average during most

Figure 1.8: Reserve Ratios, 1970-2000

Minnesota's fund balance as a percentage of wages has been consistently below the national average.



SOURCE: United States Department of Labor.

of the 1990s. Tax collections as a percentage of total wages were higher than average from 1986 to 1991 but lower than average during most of the rest of the 1990s. Figures 1.9 and 1.10 show how benefits and taxes in Minnesota have compared with national averages over the last 30 years.

Although Minnesota's overall benefit payments have not varied much from national averages, there are some interesting ways in which Minnesota's benefits differ from those in other states. In particular:

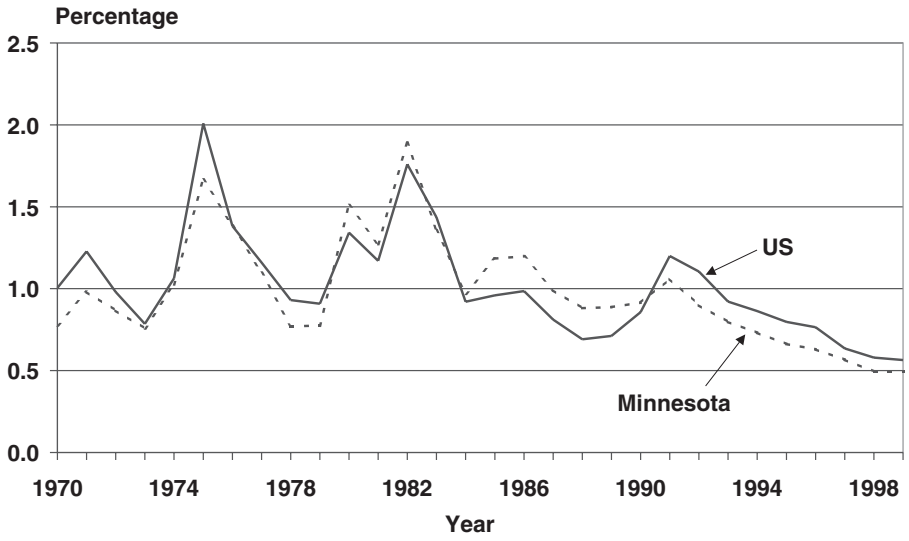
- **Minnesota has consistently paid higher than average benefits to the unemployed.**

Average weekly benefit amounts paid in Minnesota have been higher than the national average since 1974 and have been 15 to 30 percent higher than average since 1977. The higher benefit levels occur because Minnesota attempts to replace a higher share of an unemployed person's income than do other states. The data in Figure 1.11 calculate benefit levels as the ratio of the average weekly benefit amount to the average weekly wage. In 1999, the average weekly benefit amount in Minnesota was about 43 percent of the state's average weekly wage, while the national average was only 33 percent.

Minnesota has been able to pay these higher than average benefit amounts to the unemployed without necessarily having higher than average overall benefit payments as a percentage of wages. As Figure 1.12 indicates, Minnesota's unemployment rate has been consistently below the national average. During the most of the 1990s, Minnesota's insured unemployment rate was about 25 to 35 percent below the national rate. As a result, Minnesota has been able

Figure 1.9: Benefit Payments as a Percentage of Wages, 1970-99

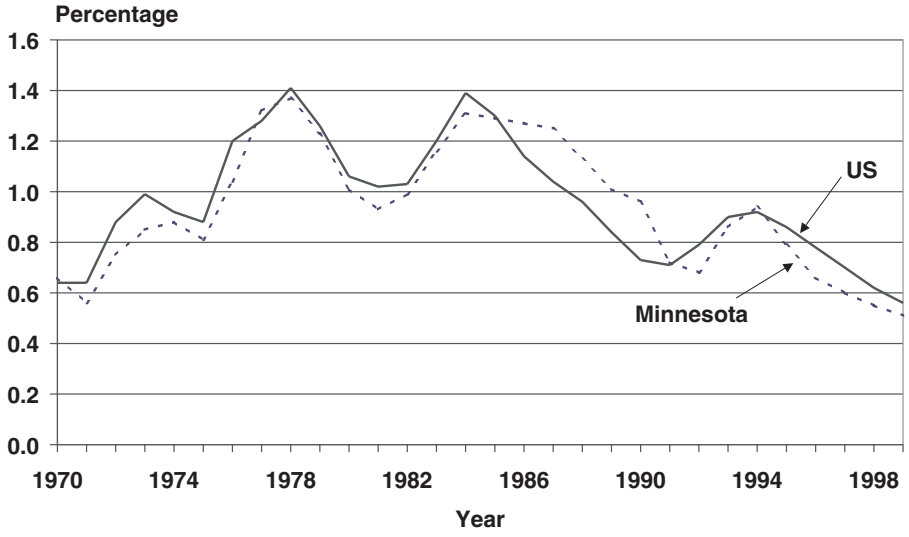
Total benefit payments as a percentage of wages have generally been below the national average during the 1990s, even though average benefits per unemployed person have been above average since the mid-1970s.



SOURCE: United States Department of Labor.

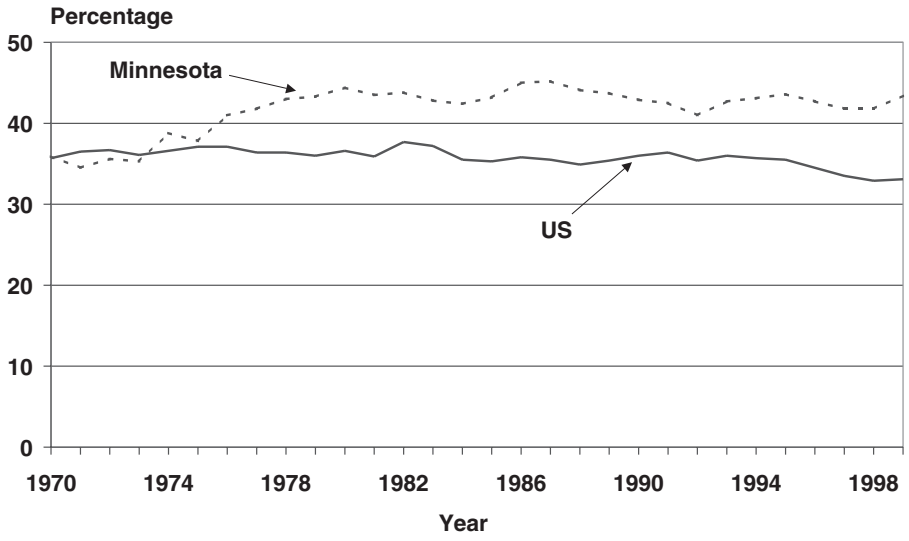
Figure 1.10: Employer Taxes as a Percentage of Wages, 1970-99

Taxes were lower than the national average during much of the 1990s.



SOURCE: United States Department of Labor.

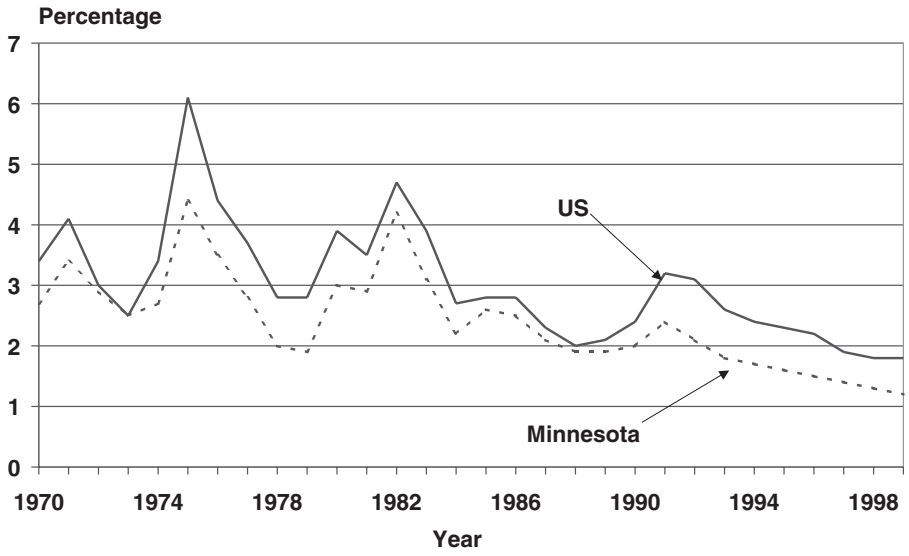
Figure 1.11: Ratio of Average Weekly Benefit Amount to Average Weekly Wage, 1970-99



SOURCE: United States Department of Labor.

Minnesota's lower-than-average unemployment rates have enabled the state to pay average weekly benefits higher than the national average.

Figure 1.12: Insured Unemployment Rates, 1970-99



SOURCE: United States Department of Labor.

to pay higher than average benefit amounts and still maintain lower than average overall benefit payments and taxes during much of the 1990s. During much of the 1980s, however, Minnesota's overall benefit payments exceeded the national average. This occurred because the state's unemployment rate was closer to the national rate than it was during the 1990s. Minnesota's insured unemployment rate was between 5 and 20 percent lower than the national rate from 1981 to 1990. Given Minnesota's higher than average benefit amounts, the state's ability to keep its overall benefit payments, as well as its taxes, below national averages has depended on the gap between the state's unemployment rate and the national rate.

Even though Minnesota's overall tax collections have been close to national averages, Minnesota's tax system varies in a significant way from those in many states. In particular:

- **Minnesota has generally had a significantly higher tax base than most states but a much lower tax rate on that base.**

From 1981 to 1999, the taxable portion of total wages has remained relatively constant in Minnesota, varying between 46 and 49 percent. In contrast, the taxable portion nationwide has fallen from 42 to 32 percent. As a result, by 1999, Minnesota's taxable portion was about half again as large as the national average. Minnesota's higher taxable portion of total wages results from the state's higher than average tax or wage base. A state's tax base indicates the amount of wages for each employee that is taxable. For example, in 2001, Minnesota taxed employers on the first $20,000 of an employee's wages. Minnesota's tax base was the 9th highest among the 50 states for 2001.

The tax rate on taxable wages in Minnesota has, however, generally been lower than the national average. In 1999, for example, Minnesota's rate was 1.1 percent while the national average was 1.8 percent. As we saw earlier, the lower rate on taxable wages more than offset Minnesota's higher tax base during much of the 1990s and resulted in lower than average tax rates on total wages. The opposite was true during the latter half of the 1980s when the state's taxes as a percentage of total wages were higher than the national average.

Minnesota appears to rely somewhat more heavily than other states on experience-based taxes.

Minnesota's tax system also appears to recover a greater percentage of benefits paid through experience rating of employers than most other states. Data from 1996 indicate that the state's experience rating index tied for the 11th highest among the 50 states. The experience rating index measures the percentage of benefits that are effectively charged back to employers whose employees received the benefits. Minnesota has a higher maximum tax rate than most states and thus, in 1996, had a smaller share of benefits that could not be charged back to employers due to the maximum rate. In addition, Minnesota appears to have had a lower share of benefits that could not be effectively charged because employers had gone out of business.

2 Fund Balance Adequacy

SUMMARY

For the last 30 years, Minnesota's unemployment insurance fund balance has not met the adequacy benchmarks used by the United States Department of Labor and others. To meet the benchmarks at the end of 2000, the state would have needed a fund balance of between $1.2 and $2.2 billion rather than the actual balance of $0.7 billion. Even a mild recession like the one experienced in the early 1990s would cause the state to borrow from the federal government for several years. Much of the problem with the unemployment insurance tax system involves the "base tax rate" schedule. Currently, the base rate stays at 0.1 percent until the fund balance is very low. This rate is not only insufficient for the purpose of building up an adequate reserve but also fails to recoup the cost of the benefits that the "experience tax rate" does not recover.

This chapter examines the adequacy of the trust fund balance for Minnesota's unemployment insurance program. Even though the trust fund balance was over $700 million at the end of 2000, we saw in Chapter 1 that Minnesota's reserve ratio is among the lowest in the nation. In order to assess the adequacy of Minnesota's fund balance, we first use the benchmarks endorsed by the United States Department of Labor and others to gauge the adequacy of fund balances.

Some analysts, however, feel that it is unnecessary to maintain fund balances as large as is called for by these benchmarks. They suggest that flexible financing features, some of which are used in Minnesota, can prevent an unemployment insurance system from needing to borrow without requiring the accumulation and maintenance of a large fund balance. As a result, we also examine Minnesota's unemployment insurance system in detail to determine its ability to avoid the need to borrow. For this purpose, we developed a forecasting model that estimates future fund balances based on assumptions about future economic conditions. The model cannot predict what future unemployment rates will be, but it can tell us how fund balances will likely respond if the state faces a recession like those faced over the last 30 years.

This chapter addresses the following questions:

- **What benchmarks are used for assessing the adequacy of state unemployment insurance fund balances? How does the size of Minnesota's fund balance compare with these benchmarks?**

- **How likely is it that Minnesota would need to borrow from the federal government? How severe would a recession have to be to deplete the state's fund balance and require borrowing?**

- **How well do the features of Minnesota law work to prevent the need for borrowing?**

This chapter focuses primarily on fund balance adequacy and the ability of Minnesota's fund to maintain a positive fund balance. States do not always need a positive fund balance, however, because the federal government provides loans to states that deplete their reserves. In the next chapter, we consider the advantages and disadvantages of borrowing and discuss the options available to state policy makers.

FUND BALANCE BENCHMARKS

The federal government uses two methods to assess the adequacy of state trust fund balances.

The United States Department of Labor uses two methods to track and assess the adequacy of state unemployment insurance trust fund balances. They are the high cost multiple (HCM) and the average high cost multiple (AHCM). In this section, we discuss these methods, their rationale, and the HCM and AHCM benchmarks that have been used to denote an adequate fund balance. In addition, we present data on how Minnesota's fund balance ranks relative to these benchmarks and the fund balances in other states.

High Cost Multiple

As we saw in Chapter 1, a state's reserve ratio measures a state's fund balance relative to its total wages. It is certainly more useful than just considering the dollar value of a state's fund balance since it takes into account wage inflation and employment growth over time. The reserve ratio does not, however, consider a state's risk of insolvency. The high cost multiple and average high cost multiple methods take that risk into account by comparing a state's reserve ratio to its experience in paying benefits during previous recessions. A state that has experienced milder recessions in the past is assumed to need a smaller reserve ratio than a state that has experienced more severe recessions.

The high cost multiple takes that risk into account by comparing a state's reserve ratio to its experience during its worst previous recession. More specifically, the high cost multiple is computed by dividing a state's reserve ratio by its high cost rate. The reserve ratio is the state's fund balance as a percentage of total wages covered by its unemployment insurance system. A state's high cost rate is the highest historical ratio of benefits to wages during any consecutive 12-month period.

The high cost multiple method has been in use since the early 1980s. In 1981, the United States Department of Labor recommended that each state maintain a multiple of 1.5 to 3.0 – namely, a reserve ratio that is 1.5 to 3.0 times a state's high cost rate. Later during the 1980s, state employment security administrators recommended a multiple of 1.5. The General Accounting Office also used a high

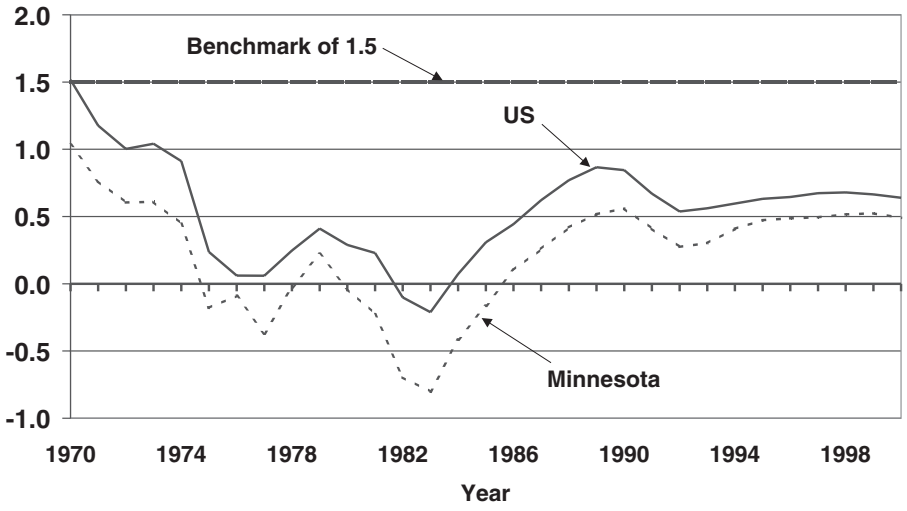
cost multiple of 1.5 in 1988 and 1993 reports that examined the adequacy of state trust fund balances. Roughly speaking, a high cost multiple of 1.5 means that a state has a fund balance that would last one and a half years if the state faced its worst previous recession and did so without collecting additional unemployment insurance taxes.

Figure 2.1 indicates how Minnesota's high cost multiple compares with other states and the benchmark of 1.5. In particular, it shows that:

- **During the last 30 years, Minnesota's fund balance, as the "high cost multiple," has been lower than the national average and well below the benchmark that is used to indicate whether a fund balance is adequate.**

Figure 2.1: High Cost Multiples, 1970-2000

Minnesota's high cost multiple is below the national average and only one-third of the recommended benchmark.



SOURCE: United States Department of Labor.

As of the end of 2000, Minnesota's high cost multiple was 0.49, or only about one-third of the recommended multiple of 1.5. Minnesota's fund balance of over $700 million represented 0.96 percent of total wages but its high cost rate from the early 1980s was 1.96 percent.

The national average of 0.64 was higher than Minnesota's high cost multiple, but only two states had multiples of 1.5 or more. Eleven had multiples of 1.0 or more. Minnesota's HCM was tied for the 39th highest among the 50 states. Only 10 states had lower high cost multiples, including several large states. New York and Texas with HCMs of 0.16 and 0.23 respectively have fund balances that are particularly vulnerable in the event of a recession.

Since the end of 2000, Minnesota's fund balance and relative position among the states has deteriorated. At the end of June 2001, Minnesota's reserve ratio fell to 0.73 percent resulting in a high cost multiple of 0.37. Minnesota ranked 45th highest with only five states having high cost multiples less than Minnesota's HCM.

Average High Cost Multiple

The average high cost multiple was developed in response to criticisms of the high cost multiple. Critics of the HCM approach said that states were unlikely to experience recessions similar in severity to those faced more than 20 years ago. In addition, they suggested that the HCM approach does not adequately account for flexible financing features of some state unemployment insurance systems such as indexed tax bases, rate schedules tied to fund balances, and solvency taxes. According to these critics, flexible financing features may make it less necessary for states to carry the high fund balances required with a high cost multiple of 1.5.

The average high cost method is calculated much like the high cost multiple except that the high cost rate is calculated differently. Under the AHCM approach, a high cost rate is computed by averaging the three highest cost rates experienced during a calendar year over the last 20 years. A state's reserve ratio is then divided by this average high cost rate to obtain the state's average high cost multiple.

In 1995, the national Advisory Council on Unemployment Compensation recommended that Congress encourage states to have an average high cost multiple of at least 1.0. The Council suggested that Congress provide this encouragement by paying higher interest rates on fund balances exceeding the recommended level. In addition, the Council recommended that states maintaining adequate balances prior to a recession be given preferential interest rates on loans should their trust funds be depleted. Although Congress did not enact these changes, the United States Department of Labor started tracking each state's average high cost multiple as well as its high cost multiple.

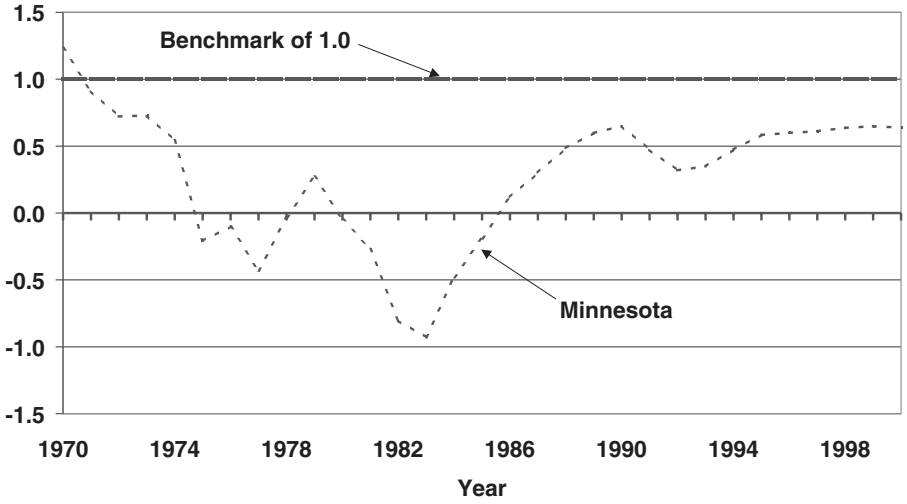
For a number of reasons, meeting the average high cost multiple benchmark requires a smaller fund balance than meeting the high cost multiple benchmark. Most obvious is the difference between meeting an AHCM benchmark of 1.0 and a HCM benchmark of 1.5. But, it is also less stringent because it excludes high cost periods that occurred more than 20 years ago. In addition, the AHCM benchmark averages the three highest cost years rather than using just the highest ones and uses only calendar years rather than the highest 12-month period.

Despite less stringent reserve requirements of the AHCM approach, Minnesota's fund balance also falls short of the recommended average high cost multiple of 1.0. Figure 2.2 shows that:

- **Minnesota has not met the recommended "average high cost multiple" benchmark since 1970.**

Minnesota's average high cost multiple is also well below the national average and the recommended benchmark.

Figure 2.2: Average High Cost Multiples, 1970-2000



SOURCE: Office of the Legislative Auditor's analysis of data from the United States Department of Labor.

At the end of 2000, Minnesota's average high cost multiple was 0.58, while the national average was 0.89. Minnesota's AHCM was the 44th highest among the 50 states. Twenty-five states had an AHCM of 1.0 or more and fund balances in another seven states were within 10 percent of the recommended levels.

Discussion

These two benchmarks of fund balance adequacy produce some very different results although Minnesota's fund falls short of meeting both of them. A high cost multiple of 1.5 would have required Minnesota to have a fund balance of $2.2 billion at the end of 2000, or about three times its actual balance of $0.7 million. Achieving an average high cost multiple of 1.0 would have required a balance of $1.2 million. A high cost multiple of 1.0, which has also been suggested by some as reasonable benchmark, would have required a balance of $1.5 billion. Clearly, Minnesota's fund balance was inadequate by any of these standards, but it is unclear which of these standards, if any, should be adopted by states.

To some extent, debate about these benchmarks cannot be fully resolved. If we knew what economic conditions we are likely to face in the future, the state could easily plan ahead maintaining only the fund balance necessary to carry the fund through economic downturns. But, that is precisely the problem; we cannot predict with accuracy what the next decade will be like. As a result, we do not know if the assumption made under the AHCM method—that economic conditions will be no worse than those experienced over the last 20 years—will be valid. Within a few years, the recession of the early 1980s will not count toward the average high cost rate calculated under the AHCM method although it can still

count under the HCM method. The relative validity of the two methods depends in large part on whether it is reasonable to expect economic conditions to become no worse than those experienced over the last 20 years.

It is important to recognize that there is no guarantee that a state would avoid borrowing by meeting any of these benchmarks. There is evidence, however, that meeting the high cost multiple benchmark does reduce the probability that a state would need to borrow from the federal government.[1] Table 2.1 shows that state funds with larger high cost multiples were less likely to borrow from the federal government. Among those states with a high cost multiple of 1.5 or more in the year prior to a recession, none borrowed from the federal government during the recessions of the early 1980s and early 1990s and only 10 percent borrowed during the recession in the mid-1970s. In contrast, among states with high cost multiples less than 0.5, 100 percent borrowed during the 1970s and 86 percent borrowed during the 1980s. A smaller share (44 percent) borrowed during the 1990s because the recession in the early 1990s was relatively mild except in certain east and west coast states.

Maintaining a large fund balance reduces, but does not eliminate, the potential need to borrow.

Table 2.1: Percentage of States That Borrowed During a Recession, by High Cost Multiple Prior to the Recession

High Cost Multiple[a]	1974-79	1980-87	1990-95
Less than 0.5	100%	86%	44%
0.5 to 0.99	86	59	14
1.0 to 1.49	42	18	0
1.5 or More	10	0	0
TOTALS	46%	60%	13%
National Average Prior to Recession	1.04	0.41	0.87

[a]A state's high cost multiple at the end of 1973 was used for the 1974-79 period. Similarly, the 1979 multiple was used for the 1980-87 period, and the 1989 multiple was used for 1990-95. The table includes the 50 states plus the District of Columbia and Puerto Rico.

SOURCE: Percentages were calculated using data from Wayne Vroman, *Topics in Unemployment Insurance Financing* (Kalamazoo, Michigan: W. E. Upjohn Institute for Employment Research, 1998), 21.

States with larger high cost multiples entering a recession also were less likely to borrow substantial amounts of money from the federal government. Table 2.2 shows that fewer than 10 percent of the states with a high cost multiple of 1.0 or more borrowed amounts of more than one percent of their total covered wages. All states with a multiple of less than 0.5 had "large" loans during the 1970s recession, and about one-third took out "large" loans during the 1980s.

Minnesota took out "large" loans during the 1970s and 1980s but did not need to borrow during the 1990s. The state's high cost multiple was 0.61 at the end of 1973 and only 0.22 at the end of 1979. The very low multiple in 1979 was due to

1 Less information is available about how meeting the average high cost multiple affects a state's probability of borrowing. The AHCM was not in use until the latter half of the 1990s and data on states' AHCMs for previous years are not available.

Table 2.2: Percentage of States With "Large" Loans During a Recession, by High Cost Multiple Prior to the Recession

High Cost Multiple[a]	1974-79	1980-87	1990-95
Less than 0.5	100%	36%	22%
0.5 to 0.99	57	29	0
1.0 to 1.49	8	9	0
1.5 or More	5	0	0
TOTALS	29%	27%	4%

[a]A state's high cost multiple at the end of 1973 was used for the 1974-79 period. Similarly, the 1979 multiple was used for the 1980-87 period, and the 1989 multiple was used for 1990-95. The table includes the 50 states plus the District of Columbia and Puerto Rico.

SOURCE: Percentages were calculated using data from Wayne Vroman, *Topics in Unemployment Insurance Financing* (Kalamazoo, Michigan: W. E. Upjohn Institute for Employment Research, 1998), 21.

the fact the state had just paid back the loans from the 1970s. The state entered the recession of the early 1980s with a very small fund. The state's high cost multiple was only 0.52 at the end of 1989. Minnesota avoided borrowing during the 1990s, however, because its economic downturn in 1991-92 was relatively mild. In addition, 1987 legislation kept the base tax rate higher than called for by the statutory tax schedule.

At some point, the costs of a larger fund balance exceed the benefits.

Some evidence suggests that it may not be cost effective to maintain a high cost multiple of 1.5. According to a 1999 study, a state with a high cost multiple of only about 1.2 could reduce the probability of borrowing during a 1970s-like recession to about 5 percent.[2] A high cost multiple of 1.5 would require a fund balance that is 25 percent larger but would only reduce the probability of borrowing a few percentage points. Use of a high cost multiple of 1.0 would, however, increase the probability of borrowing to more than 40 percent.

MINNESOTA'S FINANCING SYSTEM

The evidence cited above suggests that maintaining a high cost multiple of 1.0 or more will reduce the chance that a state fund will need to borrow from the federal government. Furthermore, it will probably reduce the chance that a state will need a "large" loan to less than 10 percent even during a major recession. Critics of the high cost multiple suggest, however, that many state tax systems are already structured with flexible financing features that will adjust to economic downturns and prevent state funds from being depleted.

In this section, we examine Minnesota's unemployment insurance tax system in greater detail. We first describe the flexible financing features used in Minnesota. Then, we examine how well these features work. In particular, we estimate how

2 Ernest Goss and James Knudsen, "Evaluation of Solvency Standards for State Unemployment Insurance Trust Funds," *Public Budgeting & Finance*, vol. 19, no. 4 (Winter 1999), 3-20.

the current tax system would respond to recessions such as those experienced in the past. We attempt to determine whether the flexible financing features of Minnesota's tax system protect the trust fund from depletion in an adequate and timely manner.

Flexible Financing Features

Minnesota's unemployment insurance tax system has a number of flexible financing features that have been in place for some time. They include an indexed tax base, a base tax rate that adjusts in response to changes in the trust fund balance, and a solvency tax that is triggered when the fund balance is low.

Minnesota's unemployment insurance tax system has some features that adjust taxes in response to changing economic conditions.

Since 1982, the state's tax base has been indexed for growth in average wages. Minnesota is one of only 17 states with an indexed tax base. An indexed tax base is particularly important in states such as Minnesota in which the maximum weekly benefit is also indexed for growth in average wages. Indexing the tax base helps taxes keep pace with changes in the average weekly benefit amount but does not help keep pace with the increased numbers of people receiving benefits during a recession. Increases in tax rates are needed to recover the costs incurred because benefits are paid to more individuals.

Another flexible financing provision in Minnesota law is the base tax rate schedule. Under this schedule, the base tax rate can vary anywhere between 0.1 and 0.6 percent. As long as the fund balance on the previous June 30th is $300 million or more, however, the base rate remains at its minimum value of 0.1 percent. Minnesota's base tax rate has been tied to the fund balance since at least the 1970s. The only exceptions were the years 1988-90 when state laws passed in 1987 set the base rates. The current base tax rate schedule became effective in 1991.

Minnesota also has a solvency tax that goes into effect if the trust fund balance was below $150 million on the previous June 30th. The current solvency tax is a surcharge of 10 percent on the unemployment insurance taxes paid by employers. The surcharge proceeds are first designated for the payment of any interest on loans from the federal government and then for payment of benefits if not needed for interest payments. The solvency tax was first enacted by the 1987 Legislature but has never gone into effect.[3]

Ability to Withstand a Recession

Clearly, Minnesota has flexible financing features in its tax system. The issue, however, is whether those features are effective enough to prevent the need for borrowing. To be effective, the tax system needs to be able to respond quickly and strongly enough to increase the fund balance before increased unemployment claims fully deplete the fund.

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3 Originally, the solvency tax was not designated for use in paying interest on loans. The surcharge would also rise to 15 percent if the fund balance on the previous June 30th were less than $75 million.

In order to assess the effectiveness of Minnesota's unemployment tax system, we developed a model that can be used to estimate future benefits, taxes, and fund balances based on economic conditions. To make such estimates, assumptions must be made about future unemployment rates and employment and wage growth. In Table 2.3, we present estimates of how Minnesota's fund balance would respond to recessions like those experienced during the last 30 years. These simulations show that:

But these features may not prevent the fund from being depleted even during a mild recession.

- **Even a mild recession like that experienced during the early 1990s would likely cause the state trust fund to borrow from the federal government over the course of about four years.**
- **Absent state or federal action to raise taxes, recessions like those experienced during the 1970s and 1980s would cause the state trust fund to borrow for at least a decade.**

Table 2.3: Response of the State Unemployment Insurance Trust Fund to Future Recessionary Conditions, 2002-2011

	Future Unemployment Rates Like Those in the:		
	1990s	1980s	1970s
Compensable Unemployment Rates: 2002-2011	Same as 1990-99	Same as 1980-89	Same as 1973-79, then constant at 2%
Percentage of Calendar Quarters in Debt[a]	37.5%	95.0%	90.0%
Lowest Balance at End of Quarter (Billions of Dollars)	-$0.5	-$1.9	-$2.1
Lowest Balance at End of Quarter (Percentage of Total Wages)	-0.5%	-2.1%	-2.4%
Balance at the End of 2011 (Billions of Dollars)	$1.1	-$0.7	-$0.3
Balance at the End of 2011 (Percentage of Total Wages)	0.7%	-0.6%	-0.3%
Average Base Tax Rate	0.38%	0.54%	0.54%
Percentage of Years With Solvency Tax	40.0%	90.0%	80.0%

[a]Percentage of calendar quarters in which the fund is in debt at the end of the quarter. There may be additional quarters in which the fund needs to borrow sometime during the quarter.

SOURCE: Analysis by the Office of the Legislative Auditor.

Some analysts might argue that the recessions of the 1970s and 1980s are unlikely to be repeated in today's "new economy." Even if they are correct, our analysis suggests that a repeat of the relatively mild recession of the early 1990s could deplete Minnesota's trust fund and result in significant interest costs to Minnesota employers.

1990s-Style Recession

A mild recession like the one experienced during the early 1990s could cause the fund to borrow a total of $500 million.

The unemployment rates experienced during the 1990s were quite low in comparison to those Minnesota faced during previous decades. The above table shows, however, that a repeat of the 1990s would likely cause the state's unemployment insurance trust fund to borrow from the federal government over at least four of the next ten years. The fund would have to borrow at least about $0.5 billion and would only have a very modest fund balance at the end of the ten-year period. The base tax rate, which was at 0.1 percent each of the last six years, would average close to 0.4 percent over the next ten years. The solvency tax, which has never been used, would be in effect four of the next ten years. Under this scenario, the fund would have needed to end the year 2000 with a balance of close to $1.6 billion in order to avoid any borrowing. A $1.6 billion balance is the equivalent of a high cost multiple of about 1.1.

Minnesota's fund is much more vulnerable today to a 1990s-like recession than it was during the 1990s. The fund was able to pay benefits without borrowing during the 1991-92 recession. But, today, the fund is more likely to borrow because of lower experience tax rates. The average experience tax rate was 1.4 percent in 1989 compared with 0.9 percent in 2000. The rate was higher in 1989 because it reflected the higher unemployment rates experienced during the 1980s as compared with the 1990s. Experience tax rates are slow to adjust during a recession because they are based on unemployment rates over the past five to six years. Even if we face the same unemployment rates as we did during the 1990s, the average experience tax rate will lag behind the rates we saw during the 1990s for the next five or six years.[4] As a result, we would expect a 1990s-like recession to cause the fund to borrow for up to four years.

1970s or 1980s Recession

If Minnesota experienced unemployment rates like those in the 1970s and 1980s, the trust fund would remain in debt for at least the next ten years, absent any action by the state and federal government to raise taxes. In either case, the fund would need to borrow at least $2 billion from the federal government. The base tax rate would rise to its maximum level of 0.6 percent after 2001 and remain there and the solvency tax would go into effect in 2003 or 2004 and remain in effect. In order to avoid borrowing under these two scenarios, the trust fund would have needed a fund balance of roughly $3 billion at the end of 2000, which is the equivalent of a high cost multiple of about 2.1.

No Borrowing Scenario

We also considered another scenario in which the unemployment rate would remain constant from 2002 through 2011. In this scenario, we used the lowest unemployment rate that did not result in any borrowing from the federal government. This "no borrowing" scenario required a compensable unemployment rate of 1.44 percent, or slightly less than the average rate of 1.46 percent over the years 1994 through 2000. These results suggest that:

4 In addition, the fund's reserve ratio at the end of 2000 was less than it was at the end of 1989. This difference is small, however, and does not explain why the fund is more likely to be depleted during the current decade than it was during the 1990s.

- **Minnesota's current unemployment insurance tax and benefit structure is able to avoid borrowing only if unemployment rates are relatively low. The flexible financing features do not appear to work quickly enough or strongly enough to avoid borrowing during even mild recessions.**

In the next section, we examine why Minnesota's financing system appears unable to either build a large enough balance to avoid borrowing or respond quickly enough to rising unemployment rates.

Analysis

Theoretically, the experience tax rate is intended to recover the benefits paid to the employees laid off by a private employer. The experience tax does not, however, fully recover the benefits paid. The incomplete recovery of benefits occurs because employers are subject to a maximum tax rate, some employers go out of business in Minnesota before being taxed on past benefit experience, and state law prohibits some benefits from being charged back to employers. In addition, the experience tax takes a long time to recoup the portion of benefits that is recovered. It does not begin to collect those benefits for at least ten months and takes up to about six and a half years to finish recovering those benefits.

Since the experience tax rate does not recoup past benefit payments, a base tax rate is applied to all employers regardless of their layoff experience. This base tax rate needs to be large enough to recover the benefits not recovered by the experience tax. If it is not large enough to recover these costs, the fund can suffer a continuous loss and may not be large enough when a recession occurs to prevent the need for borrowing.

Minnesota's main problem is its base tax rate, which is usually not high enough to recover the benefits not recouped through the experience tax.

The share of benefit costs recovered by the experience tax depends on the purpose ascribed to the 25 percent surcharge applied in calculating an employer's experience tax rate. If one considers the surcharge as repayment for the delay with which benefits are repaid, then the experience tax has recovered about 65 percent of benefits in recent years. About 35 percent have not been recovered through experience rating with roughly equal shares coming from the three major sources contributing to the non-recovery of benefits. If one considers the surcharge as contributing to the recovery of benefits, then slightly more than 80 percent of benefits are recouped through the experience tax. In that case, almost 20 percent of benefits need to be recovered through the base tax.

In either case, however, the base tax rate has not generally been set high enough to recover the benefit costs not recouped through the experience tax. In particular, Table 2.4 shows that:

- **Minnesota's base tax rate tends to stay at the minimum rate of 0.1 percent, which is insufficient to recover the benefits not recovered by the experience tax.**

Given current interest rates earned on trust fund balances, most of the 25 percent surcharge, if not all of it, could be considered compensation for the lag between the payment of benefits and the collection of experience taxes. Table 2.4 suggests

Table 2.4: Base Tax Rate Revenue Less Costs Not Recovered by the Experience Tax (in 2000 Dollars), 1985-2000

		Average Net Revenue per Year (in millions of 2000 Dollars)	
Base Tax Rate	Years at This Rate	Assumes the 25% Surcharge Compensates for the Lag in Collecting the Experience Tax	Ignores the Lag in Collecting the Experience Tax
0.1%	7	-$106	-$42
0.2	0	N/A	N/A
0.3	1	-49	11
0.4	0	NA	N/A
0.5	1	-27	38
0.6	2	0	64
0.7[a]	1	11	71
0.8[a]	1	14	69
0.9[a]	0	N/A	N/A
1.0[a]	3	7	72

[a]These rates are no longer in law. Statutes permit base tax rates of between 0.1 and 0.6 percent depending on the size of the fund balance.

SOURCE: Office of the Legislative Auditor's analysis of data from the Minnesota Department of Economic Security.

that, under this interpretation, the base tax rate may need to be as high as 0.6 percent in order for it to recover the costs not recouped by the experience rate. Currently, 0.6 percent is the maximum rate allowed and only goes into effect if the fund balance is below $200 million on June 30th. If the lag is ignored and the surcharge is instead considered as contributing toward the recovery of benefits, then the base rate would probably need to be close to 0.3 percent to recover the benefit costs not recouped by the experience rate.

The base tax rate also does not increase until the fund is close to being depleted, and the increase is not immediately effective.

Besides the inadequate recovery of benefit costs, there are additional problems with the base tax rate schedule that prevent the fund from building and maintaining an adequate balance. They include the following:

- **The tax schedule does not trigger an increase in the base tax rate over the minimum rate until the fund is very close to being depleted.**
- **Even after the fund falls low enough to trigger an increase in the base rate, it takes ten months before revenue is collected at the higher rate.**
- **The schedule is not indexed for inflation and has not changed since 1987. The fund balances that trigger rate increases have become smaller relative to total wages as wages and employment have grown.**
- **The schedule is too compressed. The base tax rate can easily go from its minimum rate one year to the maximum rate the next year.**

Minnesota's base rate tends to remain at the minimum of 0.1 percent unless the fund balance gets very low. The fund balance must get below $300 million as of June 30th in order for the minimum rate to be higher than 0.1 percent. As of the end of 2000, $300 million was only about 0.4 percent of total wages covered by

Minnesota's unemployment insurance system, or the equivalent of a high cost multiple of 0.21. If the fund falls below $300 million on June 30th, a new higher base tax rate takes effect during the next calendar year. Tax revenues are collected quarterly so the first installment of taxes at the higher rate are not due until the next April 30th—or ten months after the fund falls below $300 million. Higher benefit payments caused by a recession can easily deplete the fund before the first installment is collected.

The base tax rate schedule is also not adjusted for inflation.

The lack of indexing in the base tax rate schedule is also a concern. If the tax rate schedule had been indexed for changes in the Consumer Price Index, a fund balance of less than $460 million—rather than $300 million—on June 30, 2001 would have resulted in a base tax rate greater than the minimum rate of 0.1 percent. While the lack of indexing is a concern, it should be noted that even with indexing the base rate for 2002 would remain at 0.1 percent because the fund balance on June 30, 2001 was about $550 million. The more fundamental problem with the base tax rate schedule is simply that the minimum tax rate has to be raised before the fund balance gets below $500 million. The current recession may cause the fund balance to be depleted by late 2002 or early 2003 or before the receipt of proceeds from an increased base tax rate.

The solvency tax does not prevent the need for borrowing either. It suffers from some of the same problems as the base tax rate. It is only triggered when the fund balance is very low ($150 million) and is not indexed for inflation. Like the base tax rate, initial collections from the solvency tax are delayed ten months after the fund falls below its trigger value. In addition, while the solvency surcharge of 10 percent may be adequate to pay interest on a federal loan, it may not contribute a great deal toward reducing the fund's deficit.

In general, the flexible financing features of Minnesota's unemployment insurance system do not adequately respond to worsening unemployment conditions. Because the base tax rate tends to remain at the minimum rate, it is difficult for the fund to build an adequate reserve. The fund balance will tend to decline over time or at least not grow significantly. In addition, the base tax rate and the solvency tax do not respond quickly enough to prevent the fund from being depleted when unemployment rates increase.

Declining unemployment rates are an exception to the general rule that the minimum rate of 0.1 percent will generally cause the fund to decline. During the 1990s, Minnesota benefited from low and declining unemployment rates. Revenues exceeded benefits and the fund balance grew modestly. The growth was a result of an experience tax rate based on past unemployment rates that each year were higher than the current unemployment rate. Even this favorable unemployment trend during the 1990s did not produce a very significant increase in the fund balance. The fund grew to about $700 million or less than 1 percent of total wages. The high cost multiple was slightly less than 0.5. Furthermore, if the unemployment rates continue to increase as in 2000 and 2001, the fund will find itself on the opposite side of this trend. The current year unemployment rate will exceed the rates on which the experience tax rate is based. Revenues will fall short of benefit payments and the fund balance will fall.

3 Policy Options

SUMMARY

Minnesota's unemployment insurance trust fund could be easily depleted during a mild recession. The Legislature should consider ways of building and maintaining a larger fund balance. Building a larger trust fund balance would help avoid interest charges on borrowed monies, reduce the need to raise taxes or cut benefits during a recession, and permit the state greater flexibility in deciding how to distribute the tax burden among employers. At a minimum, the Legislature should make changes in the financing system so that the base tax rate recovers the benefit costs not recouped by the experience tax rate. The Legislature should also consider changes in the solvency tax statute. Under the existing statute, the state could owe interest charges to the federal government without having a legal means of paying the interest. The Department of Economic Security, or its successor agency, should investigate whether the state could issue short-term certificates of indebtedness and reduce the interest costs on any future borrowing by the state trust fund.

In the last chapter, we saw that Minnesota's unemployment insurance taxes do not build and maintain an adequate fund balance. Even mild recessions could cause the trust fund to borrow from the federal government. This chapter considers the advantages and disadvantages of maintaining a larger fund balance and examines a number of policy options. In particular, the chapter addresses the following questions:

- **What are the advantages and disadvantages of maintaining a larger unemployment insurance fund balance?**
- **What alternative ways could the Legislature use to maintain a larger fund balance?**
- **What additional changes in the financing system should the Legislature consider?**

DISCUSSION

It is clear that Minnesota's fund balance can be easily depleted during a mild recession. But, it is also apparent that a fund deficit does not jeopardize the payment of unemployment benefits. States can readily borrow funds from the

federal government for this purpose, and the federal government currently has adequate resources available to make such loans. State tax increases, as well as mandated federal tax increases, may be required to repay those loans as was the case in Minnesota during the 1980s.

Those opposed to maintaining a larger fund balance would rather increase taxes if and when they are needed.

As a result, some analysts and interested parties have argued that states should not carry fund balances as large as the United States Department of Labor recommended during the 1980s. In addition, some argue that the revised benchmark that uses an average high cost multiple of one may still be excessive. They suggest that tax increases can be put into effect when needed rather than in anticipation of a recession that may never arrive. Business lobbyists in Minnesota are also concerned that a large fund balance might be used to increase benefits rather than reserved for use during a recession. Benefit increases could include a general increase in benefit levels, special legislation authorizing additional benefits for workers involved in mass layoffs by certain employers, or the payment of unemployment insurance benefits to parents who voluntarily take time off to care for a child.

Proponents favoring maintenance of an adequate fund balance cite a number of reasons for funding unemployment insurance benefits in advance of a recession. First, they cite the extra cost incurred by states that borrow from the federal government. Since April 1, 1982, the federal government has charged interest on loans to states. The interest rate is tied to the rate of return earned by the federal government on the federal Unemployment Trust Fund but is capped at 10 percent. During the 1980s, Minnesota paid significant interest costs since the interest rate was 10 percent. For 2001, the interest rate applicable to loans was 6.4 percent. A state that builds an adequate fund balance and does not need to borrow avoids interest costs and receives comparable interest from the federal government on its fund balance.

Maintaining a larger fund balance can help the state's employers avoid the potential high costs of borrowing.

The interest costs to Minnesota employers could be substantial during even a mild recession. We estimate that interest costs could be as much as $50 million over a four-year period if the unemployment rates of 1990-99 were repeated over the next ten years. If the state once again experienced the unemployment rates of the 1970s or 1980s, the trust fund might need to borrow as much as $2 billion and could potentially need to pay cumulative interest costs of about $700 million. These interest costs would likely be lower since tax increases would probably be implemented and would reduce the amount and duration of loans.

Second, if a loan is not paid back within about two years, the federal government imposes an additional tax on all private employers in the state who pay the federal unemployment insurance tax.[1] In the first year, the tax is 0.3 percent on the first $7,000 of an employee's earnings. The tax can increase by as much as another 0.3 percent each year that a loan balance is outstanding. While the tax is used to repay the state's loan, the imposition of the tax limits a state's ability to determine for itself the best way to repay the loan. A state may prefer to impose a different type of tax—such as a percentage surtax on employers—rather than having all employers, including those who have not laid off workers, pay the additional tax.

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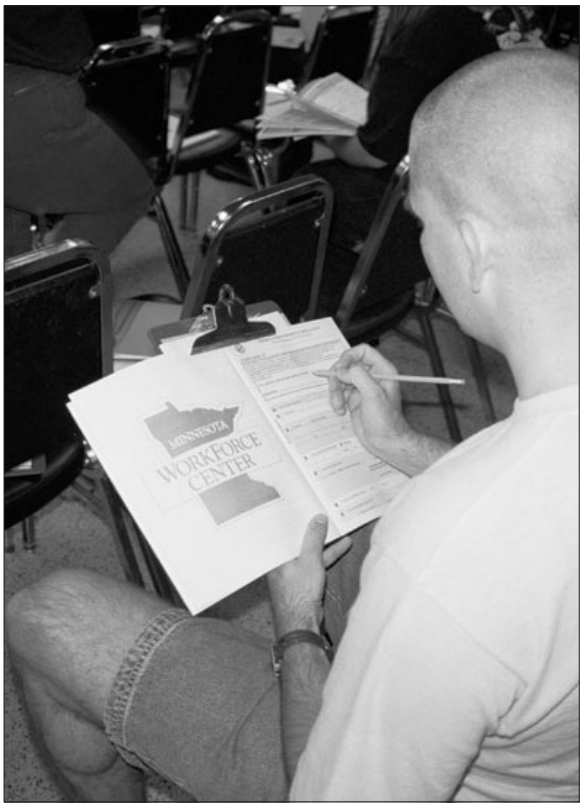
1 If the loan is outstanding on January 1st of two consecutive years and not paid back in full before November 10th of the second year, the federal government begins to impose the additional tax in that year.

During the 1980s, an additional federal tax was imposed for four years. By the fourth year, the additional tax had increased to 1.1 percent.

Third, incurring debt during recessions may add to the tax burden on employers during tough economic times and perhaps prolong the recession. Proponents of maintaining an adequate fund balance argue that it is better to tax employers during good economic conditions than to tax employers during a recession. This argument generally holds true but may not be valid if a recession is very short. During a very short recession, tax increases could be triggered but not take effect until the recession is over.

Fourth, maintaining an adequate fund balance can also prevent a state from reducing unemployment benefits during an economic downturn when they are needed most. Benefits have been reduced during recessions in a number of states. From a macroeconomic viewpoint, the unemployment insurance system is believed to provide some automatic stability to the economy. The system should stimulate the economy during recessions by replacing some of the income lost by those who have lost their jobs. In addition, it should build up adequate reserves during good economic times. Collecting taxes during good times helps to keep inflation in check, while collecting taxes during recessions tends to worsen the recession. To the extent that states fail to build up adequate reserves in good times, these stabilizing features of unemployment insurance can be diminished.



A larger fund balance can help avoid the need to reduce benefits and increase taxes during a recession.

Finally, maintaining an adequate balance is good insurance in case the federal government increases the costs or penalties associated with borrowing or increases the rewards associated with maintaining an adequate fund balance. Minnesota started the 1980s with a very small fund balance and had to pay significant interest costs when the federal government started to charge interest on new loans made in 1982 at the height of the 1980-83 recession. In 1995, the federal Advisory Council on Unemployment Compensation recommended a number of changes that would reward states that maintained a fund balance equal to an average high cost multiple of one. These financial incentives were not adopted by Congress but might be considered again if significant borrowing occurs in the future.

It is difficult to make a specific recommendation on the size of the state's fund balance.

In general, we think that the arguments in favor of maintaining an adequate fund balance make sense. It is difficult, however, to make a specific recommendation about the size of the fund balance that should be maintained. No one can predict the severity, duration, and frequency of future recessions. As a result, it is difficult to say how large a balance is needed to avoid borrowing. In addition, policy makers may not want to entirely avoid the possibility of borrowing. The costs of building a fund balance large enough to withstand any recession may be excessive when compared with the costs of borrowing. Research furthermore suggests that, for a state with a fund balance equal to 1.15 to 1.20 times its high cost multiple, the costs of building a larger fund balance outweigh the benefits. At that point, only very small reductions in the probability that borrowing will be needed can be achieved by increasing the size of the fund balance.

RECOMMENDATIONS

Building a Larger Fund Balance

Because of the uncertainty over future economic conditions and the inherent policy decisions involved, we do not offer a specific recommendation regarding the size of Minnesota's fund balance. But, in our view, the current funding system is inadequate. The current system fails to fully recover the cost of past benefit payments. The base tax rate is too frequently set at its minimum rate and that rate fails to recoup the socialized costs that the experience tax rate does not recover. Minnesota's fund balance has been able to grow during the 1990s despite this problem because unemployment rates have been relatively low and have declined. While we cannot predict future unemployment rates, it is difficult to imagine that the good fortune of the 1990s will be repeated during the next decade. Even if it were repeated, our model suggests that a repeat of the 1990s might cause the state's trust fund to borrow over four of the next ten years. The fund and the base tax rates are simply not as well positioned for a modest recession as they were in the late 1980s.

But the current fund balance is too low, and the base tax rate schedule needs to be changed.

It may be difficult to build up the trust fund balance in the near future due to the recession that started in 2001. But, as the recession ends, the Legislature should consider ways in which a larger fund balance can be built up and maintained. Because of the vulnerability of the fund to even mild recessions, we think that changes in the financing of the unemployment insurance system are needed.

RECOMMENDATION

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 the costs of past benefits are fully recovered.

One way to build and maintain a larger fund balance would be to overhaul the base tax rate schedule. The current schedule is too compressed, not indexed for growth in either wages or employment, and does not trigger a rate higher than the minimum rate until the fund balance is very low relative to the total wages covered by the system. During 2002, the minimum rate collected only $21 per employee and less for employees earning less than $21,000 per year. These collections fail to cover the costs of benefits that are not recovered through the experience tax rate.

The Legislature may want to consider an alternative approach that places more of the tax burden on employers whose employees have received unemployment insurance benefits. Some states have applied varying surtax percentages to experience tax rates depending on the fund balance. This approach could be used to build and maintain a larger fund balance without requiring employers without layoff experience to finance as much of the cost.

The Legislature may also want to consider reductions in benefit levels as a way of building a larger fund balance. One justification for cutting benefits would be that Minnesota's average weekly benefit is well above the national average. But benefit levels even in Minnesota are not particularly high by some standards. Currently, an unemployed person's weekly benefit can be as high as two-thirds of the state's average weekly wage, but the average weekly benefit is only about 43 percent of the state's average weekly wage. According to a 1995 report from the national Advisory Council on Unemployment Compensation, there has been a long-standing national goal of setting benefits so that they replace 50 percent of lost wages. Benefits in most states, however, fall short of meeting that goal. To help meet the goal, the council endorsed setting a state's maximum weekly benefit amount equal to two-thirds of the state's average weekly wage, as is currently the practice in Minnesota.[2]

The Legislature and the Department of Economic Security may also wish to consider changes in the tax system that reduce the amount of time between the recognition that additional taxes are needed and the actual collection of taxes. Currently, it is not possible to quickly change base tax rates or institute a solvency surcharge in response to the fund's condition. But, as the department's computer systems are overhauled, quarterly adjustments in tax rates may become possible and could become a way of more quickly addressing a declining fund balance. One disadvantage of this approach is that it might make it more likely that taxes would increase during an economic downturn.

Given the current computer system constraints, one possibility that would somewhat address the delay problem would be to base each year's base tax rate on the benefit cost rate experienced during the 12-month period ending on September 30th of the previous year. The benefit cost rate could be measured by the benefits paid divided by the wages covered by the unemployment insurance system.[3] This approach does not permit quarterly adjustments to tax rates. It simply allows

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2 Advisory Council on Unemployment Compensation, *Unemployment Insurance in the United States: Benefits, Financing, and Coverage* (Washington, D.C.: February 1995), 20.

3 Covered wages may need to be drawn from an earlier 12-month period due to data availability limitations.

more up-to-date information to be used in setting the annual base tax rate. It also permits the base tax rate to be adjusted in response to overall benefit payments rather than in response to the fund balance.

Other Issues

Solvency Tax

Changes in other aspects of unemployment insurance financing should also be considered. In particular, the solvency tax statute merits attention.

RECOMMENDATION

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 solvency tax statute does not always provide a source of funds to pay interest costs.

The solvency surcharge provides a means of paying interest on loans from the federal government, as well as providing additional resources to the trust fund when it is depleted or close to being depleted. The existing statute, however, will not always trigger the surcharge in time to generate revenue to pay interest. It is possible for the fund to be in deficit during a calendar year and owe interest to the federal government by September 30th of that year even though the fund balance was greater than the trigger value ($150 million) on the previous June 30th. The federal government does not permit a state to pay interest directly or indirectly from its account in the federal Unemployment Trust Fund and may impose severe penalties if a state does not pay interest from a permitted source.

This loophole could become a problem in 2003 if the assessment is not triggered in June 2002 and the fund needs to borrow in late 2002 or early 2003.[4] As a result, it is important to close this potential loophole in the solvency tax statute.

Managers in the Minnesota Department of Economic Security (MDES) are aware of this problem and have been researching possible solutions. One concern that has been raised, however, is that the proceeds of any solvency surcharge could be tapped by the Legislature and used for other budgetary purposes. While this might be tempting given the current state budget deficit, it is important to recognize that the solvency surcharge provides an essential function. If the state does not have the revenue to pay interest charges when they are due, the state's employers may have to pay a federal tax of 6.2 percent, rather than 0.8 percent, on the first $7,000 of each employee's wages.

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4 For example, if Minnesota's trust fund needs to borrow from the federal government during the first four months of 2003, then interest on those loans would be due to the federal government by September 30, 2003. Since Minnesota's fund balance may exceed $150 million on June 30, 2002, the solvency tax would not be in effect for 2003.

Reserve Fund

Some states have used a reserve fund to accumulate part of the resources used to pay benefits during a recession.

If the Legislature wishes to build up its fund balance, it may also wish to consider establishing a reserve fund. Four states—Idaho, Nebraska, North Carolina, and Oregon—have set up reserve funds to hold a portion of the resources that are available to pay benefits in the event that the state's unemployment insurance fund runs out of money. A state is permitted to use a reserve fund to receive funds that might otherwise be deposited in the state's unemployment insurance account in the federal Unemployment Trust Fund.[5] The advantage of a reserve fund is that the interest earned on the fund can be used to pay for labor market programs or administration of the state's unemployment insurance or employment services programs.

One possible use of a reserve fund in Minnesota would be to pay bank fees charged to the state for the operation of the clearing account in the state's unemployment insurance fund. Currently, the state has been delaying the deposit of the account's receipts into the federal trust fund until they earn sufficient interest to offset the fees. The interest earned on the account is lower than would be earned in the trust fund account (3 percent compared with 6.4 percent). The federal government, however, does not permit a state to pay bank fees from unemployment insurance tax receipts. Reserve fund interest earnings would likely be larger than the earnings on the clearing account and could be used to pay the bank fees. Thus, a reserve fund could potentially save the state money while also making interest earnings available for other employment programs.

The main concern about a reserve fund is that its balance, unlike the state's balance in the federal trust account, could potentially be used for purposes other than the payment of unemployment insurance benefits. The Legislature, with the Governor's approval, could change the law setting up the reserve fund and use the accumulated monies for other purposes such as reducing a state budget deficit. While this has not happened yet in the states with a reserve fund, it is a potential concern.

Alternatives to Federal Loans

Some states have issued state debt rather than borrowing from the federal government.

Three states—Connecticut, Louisiana, and West Virginia—have issued state debt instruments rather than borrowing from the federal government. While their experience has been mixed, it is possible for a state to reduce its interest costs by issuing bonds or short-term certificates of indebtedness. During the last 15 years, interest rates on state debt have generally been lower than the rate charged by the federal government on trust fund loans. If a state is able to anticipate its borrowing needs and issues debt instruments with an appropriate mix of maturities and call options, a state can save money on interest costs by issuing state debt.

It should be noted that, in accordance with federal law, a state cannot use monies from the unemployment insurance trust fund to repay state-issued debt. A state may repay such debt by establishing a separate payroll tax on employers. That tax would only need to be in effect while debt is being repaid. In addition, the tax

5 A state must designate the tax and tax rate that is used to fund the state's reserve fund. It cannot base that tax rate on the size of its account balance in the federal Unemployment Trust Fund.

could be smaller than the additional taxes that would be needed if the state borrowed instead from the federal government.

We suggest that the Department of Economic Security investigate alternatives to federal borrowing. It appears to us that the full-range of borrowing options is not available in Minnesota due to constitutional restrictions. The Minnesota State Constitution does not appear to permit the issuance of long-term bonds for the purpose of paying unemployment insurance benefits. However, the Constitution does permit the issuance of short-term certificates of indebtedness if they are used to raise funds in anticipation of taxes that will be received during a biennium. It is possible that state certificates of indebtedness, when combined with the short-term interest-free loans available to the federal government, could be used to reduce the state's interest costs during a period of borrowing. This option warrants further investigation.

RECOMMENDATION

The Minnesota 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.

The department, or its successor agency, should report back to the Legislature on the legality and potential usefulness of issuing short-term state debt.

Summary of 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 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 Minnesota 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.

Further Reading

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State of Minnesota
Department of Economic Security

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Office of the Commissioner

January 15, 2002

James Nobles
Legislative Auditor
Office of the Legislative Auditor
Room 140 Centennial Building
658 Cedar Street
St. Paul, MN 55155-1603

Dear Mr. Nobles:

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. During the last half of the 1990's, a growing trust fund, unprecedented economic growth and historically low unemployment rates masked the vulnerability of the fund. During these years the fund fell far short of all recognized measures of solvency; though the fund balance was increasing, it was doing so primarily due to interest earned while revenues and payments were roughly equal.

This situation would not have been a problem but for two critical factors: first, the fund balance was too low when compared to the potential risk in an economic downturn; second, the statutory triggers for base rate tax increases were (and are) intended to keep the fund from going into deficit rather than to keep the fund at solvency levels. As the Legislative Auditor's report points out, the base tax rate has been at the minimum rate too often. In fact, under current law the base tax does not move above the minimum rate until the fund status is critically low and likely to go into deficit. 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.

I would point out that the issue of bank charges raised in the report is being addressed through a partnership between the Department of Revenue and the Department of Economic Security. The UI tax type will be added to the Department of Revenue's "E-Pay Minnesota" on line system in April, 2002. That will begin to remove the dependency on bank processing for unemployment insurance receipts. Other cooperative actions are planned which will further reduce or eliminate the bank charges in the future.

The report's recommendation that the Department of Economic Security should investigate whether the state could issue short term debt to reduce the costs of borrowing from the federal government is good. I feel however, that the expertise for such an analysis may exist primarily in the Department of Finance. The two agencies should work closely together if so directed by the Legislature.

Finally, I will note that the UI computer systems which support this activity are old and inflexible. We are beginning to reengineer those systems, a process that will continue over the next several years. Revamping these systems is critical if policy options are not to be limited due to system constraints.

Sincerely,

/s/ Earl Wilson

Earl Wilson
Commissioner

EW:dka

C: Matt Smith
Rebecca Yanish
Amy Gromer
Pam Wheelock

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