Members Only

AN INFORMATIONAL BRIEF PREPARED FOR MEMBERS OF THE OHIO GENERAL ASSEMBLY BY THE LEGISLATIVE SERVICE COMMISSION STAFF

Volume 133 Issue 4
October 9, 2019

Financing Unemployment Benefits – Federal Loans to Cover Shortfalls*

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This brief explains the federal-state partnership for unemployment benefits, the "normal" mechanism that funds unemployment benefits, the procedure by which Ohio has obtained loans from the federal government to continue uninterrupted funding of Ohio's unemployment compensation system, and the consequences of obtaining those loans.

Introduction

By the end of 2008, Ohio's Unemployment Compensation Fund – the fund used to pay eligible unemployed individuals benefits[1] – was depleted. The Fund became insolvent in January 2009. Ohio borrowed a total of $3.39 billion[2] from the federal government in 2009 through 2014 and paid interest on the loan totaling $257.7 million.[3] This debt was repaid on August 30, 2016, following the passage of H.B. 390 of the 131st General Assembly. That act required a one-time loan from unclaimed funds to pay off the debt, and required each experience-rated contributory employer to pay an increased contribution rate in 2017 to repay the loan from unclaimed funds.[4] According to the Ohio Department of Job and Family Services (the agency that administers unemployment compensation in Ohio), three factors contributed to the insolvency:

1. An increase in the number of job losses due to the Great Recession, resulting in substantially more individuals than usual filing claims for unemployment benefits;

To cover the shortfalls of Ohio's Unemployment Compensation Fund, Ohio borrowed a total of $3.39 billion from the federal government in 2009 through 2014 and paid interest totaling $257.7 million.

Although the debt was repaid, the Fund remains in a precarious position. Due to a low amount of reserves, a recession may result in depleting the Fund.

*This *Members Only* brief is an update of an earlier brief dated April 10, 2009 (Volume 128, Issue 6).

In the 1930s, the federal government utilized a "carrot" and "stick" approach to induce all states to establish an unemployment benefits program. The stick was a hefty federal excise tax on the payroll of most employers; the carrot was a 90% tax credit to any employer paying contributions (at a much lower rate) to support an "approved" state unemployment compensation program.

2. While under Ohio law, unemployment benefits must increase with inflation, employers' tax rates remain generally constant;[5] and

3. The Fund was not adequately replenished following the prior recession in the early 2000s.[6]

Although the debt was repaid, the Fund remains in a precarious position. In 2018, the Fund paid out $863 million in benefits and took in deposits of $1.131 billion. The year-end balance for calendar year 2018 was $943 million. Due to the low amount of reserves, a recession might result in depleting the Fund.[7]

The federal-state partnership

The modern Ohio unemployment compensation system has its origins in the mid-1930s during the Great Depression.[8] Although individual states initially attempted to address the national problem, Congress ultimately determined to address the situation nationally. However, U.S. Supreme Court decisions on legislation passed during the New Deal Era held that a state could not be forced to participate in a federal program or to become agents of the federal government for such a program.[9] Accordingly, instead, Congress enacted the Federal Unemployment Tax Act (FUTA) that utilized a "carrot" and "stick" approach, offering states incentives to establish unemployment insurance programs that satisfied minimum federal standards.[10]

The "stick" is a hefty federal excise tax levied by Congress under its taxing power on the payroll of almost every employer in the country.[11] The "carrot" is an offer to waive almost 90% of that tax if the employer makes payments, somewhat euphemistically called "contributions," to an "approved" state unemployment compensation system (the employer receives a credit for the state contributions). The U.S. Supreme Court upheld this carrot and stick approach.[12]

These incentives proved to be enough, rapidly, to encourage all states to set up a program that satisfied the federal standards, essentially since the legislation also offered an additional "carrot" directly to the states. The federal government pays a share of a state's administrative costs to run an approved state program out of the proceeds of that portion of the excise tax the federal government still directly collects. A third carrot allows an employer to receive an additional tax credit if a state establishes an experience rating system in accordance with federal requirements to determine how an employer contributes to the state's unemployment compensation fund (this credit, plus the tax credit discussed above, cannot exceed 5.4%).[13]

How the system is funded under "normal" conditions

FUTA requires each state to establish a state unemployment compensation fund to pay unemployment benefits in order for employers to receive the FUTA tax credit.[14] Ohio has an approved unemployment compensation system[15] and approved experience rating system. Thus, Ohio employers receive the full FUTA tax credit during times when Ohio does not have outstanding loans.

The basic funding mechanism used by all states is to establish, for those employers who are subject to the state's unemployment compensation law, an account within the state's unemployment compensation fund and to periodically collect (in advance) contributions from almost all of those employers. The formula for calculating those contributions depends on the balance in each employer's account and the outflow of money from that account to pay benefits chargeable to that employer. These types of employers are commonly known as "contributory" employers. When the system is operating normally, each employer should have sufficient funds in its account to cover any benefit charges against the employer. As the balance in an employer's account goes down, the employer's future rate of contributions will increase to replenish those losses. If, on the other hand, an employer continues to build up the balance in its account because there are few if any changes to the account, gradually, the employer's contribution rate will decrease.

In the 1970s Congress undertook a major extension of the program to cover virtually all state and local government agencies and nearly all nonprofit employers. In contrast to contributory employers, governmental and nonprofit employers generally were granted the option to reimburse the system after benefits have been paid. (Nonprofit employers still retain the option of being contributory employers.) These types of employers are commonly known as "reimbursing" employers. The status of being either a contributory or reimbursing employer each has advantages and disadvantages, but from a systemic point of view, the reimbursing option has a disadvantage because no "cushion" of money is added to a state's unemployment compensation fund to help deal with the higher payout of benefits during a deteriorating economy.

Ohio has other mechanisms to help maintain the solvency of Ohio's Unemployment Compensation Fund. Ohio law creates a mutualized account within the Fund that generally is used to keep the Fund balance at a safe level and to cover the payment of unemployment benefits when responsibility for that payment, although justified, cannot be attributed to an individual employer. A "mutualized tax" (a type of surtax) is applied only under certain circumstances and is applied uniformly to all contributory employers. It is not currently being applied. The mutualized tax does not affect an employer's experience rating.[16]

Also, Ohio law includes a requirement for calculation of a minimum safe level (MSL). If the Fund, as of the "computation date" (July 1), is above or below the MSL, the contribution schedule specified in statute for the next calendar year is adjusted based on the percentage that the Fund balance is above or below the calculated MSL.[17] This additional cost to employers is known as the MSL tax. The Fund is more than 60% below the minimum safe level as of the computation date for 2019 rates. As a result, there has been an across-the-board MSL tax increase for 2019 to help rebuild the Fund. The MSL tax revenue is split equally between the mutualized account and the employer's account.[18]

Given "normal" economic conditions and a relatively low and stable unemployment rate, a state program produces sufficient revenues to pay all benefits to unemployed individuals and maintain an adequate level of reserves.

What happens if Ohio's Unemployment Compensation Fund is unable to pay benefits?

Despite all the features designed to ensure that money to pay unemployment benefits is readily available when needed, several periods of distressed economic conditions have existed that pushed states' unemployment compensation funds into insolvency.

Prolonged periods of economic distress and high unemployment rates can deplete a state's reserves. Federal law allows states faced with insufficient reserves to borrow money ("advances") to continue the uninterrupted payment of unemployment benefits.

What happens if such a serious situation develops? Do people not get paid benefits? No. It appears that, under the federal-state partnership, a state must find some way to pay unemployment benefits. FUTA allows states to determine the amount of unemployment benefits they will pay. However, for a state system to comply with FUTA, it would appear that the state has to be able to pay whatever unemployment benefit amount the state establishes.[19]

Ohio has faced such difficulties before, most recently by the end of 2008. In the early 1980s, many states had been suffering from the recession of the late 1970s and early 1980s, and a strain was placed on their unemployment compensation funds. Ohio, along with several other states, had to obtain advances from the federal government to pay unemployment benefits. Ultimately, Ohio borrowed $2.8 billion from the federal government.[20] In the late 1980s and early 1990s, when Ohio's fund again was threatened with insolvency, the General Assembly enacted changes to the state law and was able to avoid obtaining an advance from the federal government. Those changes included gradually increasing the taxable wage base (thus gradually increasing employer taxes), increasing the minimum safe level tax (discussed above) if the Fund was more than 60% below the minimum safe level, increasing the amount of earnings one must have to qualify for benefits, and temporarily modifying contribution rates, among other changes.[21]

Potential immediate funding options if the Fund is insolvent

To continue paying unemployment benefits if the Fund is insolvent, Ohio must find a way to immediately inject funds into the system. Two sources appear to need legislative action: (1) using funds from another state source or (2) issuing bonds.

However, tapping other state revenue sources could risk the state losing its "approved" status, if the funding mechanism does not satisfy federal requirements regarding how a state's system must be established for employers to receive the FUTA tax credit. Furthermore, the state may not be able to use other sources because Ohio limits how those other sources may be spent. For example, the Ohio Constitution and implementing statutes limit using the State Insurance Fund for purposes unrelated to workers' compensation.[22]

Also, based on an Ohio Supreme Court decision, it does not appear that Ohio could issue bonds to cover the shortfall without amending Ohio's Constitution. In the late 1980s, the General Assembly amended the Unemployment Compensation Law to permit the issuance of bonds to repay the outstanding federal loans Ohio received. The Supreme Court held that the bonds to be issued did not fall under any exception to the prohibition against creating debt that exceeds $750,000, and thus the debt would violate Ohio's Constitution.[23]

Another option, however, which does not require constitutional amendment or legislation, is to obtain an advance (loan) from the federal government to pay unemployment benefits, as discussed below.

Obtaining a federal advance

Federal law permits a state's governor, or the governor's designee (in Ohio, the Director of Job and Family Services) to apply to the U.S. Secretary of Labor to receive a three-month "advance" for payment of unemployment benefits if the amount in a state's account in the federal Unemployment Trust Fund is insufficient to pay those benefits.[24] The Secretary may allow an advance if both of the following requirements are satisfied:

1. The governor applies for the advance no earlier than the first day of the month preceding the first month of the three-month period; and

2. The governor furnishes an estimate of the amount of an advance the state will need for payment of unemployment benefits during each month of the three-month period.[25]

If a state applies for an advance, the Secretary of Labor must determine the amount, if any, that will be required for payment of benefits during each month of the three-month period, and must certify that amount to the Secretary of the Treasury. The amount the Secretary of Labor certifies to the Treasury Secretary, and the amount the Treasury Secretary transfers to the state's account from the Federal Unemployment Account (FUA) on a monthly basis, cannot exceed the amount estimated by the governor nor the amount the Treasury Secretary reports is available in the FUA for advances during each month.[26] To obtain an advance, a state must determine the amount required to pay compensation in any month, with due allowance for contingencies, and must take into account all other amounts that will be available in the state's unemployment compensation fund to pay compensation that month. "Compensation" does not include administration expenses.[27]

Repayment of an advance

The governor of a state that has received an advance has many duties regarding applying for and repaying it. A governor may, at any time, request that funds be transferred from the state's account in the federal Unemployment Trust Fund to the FUA to repay part or all of an advance.[28]

Consequences of obtaining an advance

FUTA sets deadlines for states to repay federal advances. If a state does not repay as required, the basic penalty is a "graduated" loss of the federal excise tax credit for all employers in the state.[29] Any increase in the FUTA tax then is used to repay that state's outstanding advance balance. Additionally, a state may lose additional funding and may be charged interest if advances remain unpaid.

Under normal conditions, an employer who regularly pays into an approved state system has a FUTA tax rate that equals 0.6% after taking the allowed tax credit (6% tax minus the 5.4% tax credit). If, for example, an employer has a taxable payroll of $10,000, under normal conditions the employer pays only $60 per year in FUTA taxes to the federal government ($10,000 x 0.006).

A state's governor or the governor's designee may apply for an advance with the U.S. Secretary of Labor to pay for unemployment benefits in an upcoming three-month period if the state is unable to pay for those benefits from its account in the federal Unemployment Trust Fund.

Advances must be repaid according to a strict timetable, with the penalty of a gradual reduction of the federal tax credit to employers if a state fails to meet the repayment deadlines.

If a state has an outstanding balance as of January 1 for two consecutive years, the state has until November 10 of the second year to pay off that balance. If the state does not pay off the balance by that date, the FUTA tax credit in that state is reduced by 5% of the FUTA tax. Thus, the employer in the example would pay an additional $30 per year (approximately) in FUTA taxes if the advance made to the state remains outstanding after the deadline passes (6% x 5% = 0.3%; $10,000 x 0.003 = $30). An employer's FUTA tax credit is reduced by an additional 5% per year for each succeeding year an advance remains outstanding.[30]

If, beginning in the third and fifth consecutive years the balance of an advance remains outstanding and other conditions are not met, the FUTA tax credit is reduced by 5% as described above plus an additional amount calculated in accordance with prescribed formulas. The additional reduction that applies beginning in the fifth year is higher than the reduction that applies in the third or fourth year.[31]

If, while collecting all of these additional taxes, the balance of any advance is paid in full, the remainder no longer needed to repay the advance must be placed in the state's account in the federal Unemployment Trust Fund.[32]

Under normal conditions, if amounts in other accounts with the federal Unemployment Trust Fund have reached statutorily prescribed limits, the excess funds are divided and transferred to the states' accounts. However, if a state has an outstanding advance balance, any excess the state would have received is kept in the FUA to reduce that state's balance.[33]

Current employer tax rate

The FUTA tax rate is 6% on the first $7,000 of each employee's taxable wage ($420 per employee). Ohio currently has an approved system and does not have outstanding advances, thus Ohio employers currently receive the full tax credit and are subject to a 0.6% FUTA tax rate ($42 per employee). In contrast, before Ohio paid off the balance of the advances in 2016, the FUTA tax credit for Ohio employers was gradually reduced so that they were subject to a rate of 2.1% ($147 per employee) for 2015.[34]

Interest on advances

Federal law does not require a state to pay interest on advances if (1) the advances are paid in full by September 30 of the calendar year during which the advances were made, (2) no other advances were made during that calendar year and after the repayment is complete, and (3) the state meets funding goals in regulations issued by the Secretary of Labor concerning state accounts in the federal Unemployment Trust Fund.[35]

Otherwise, the state must pay interest on an advance.[36] Ohio has been unable to repay advances before interest accrued in the past. The advances Ohio received in the 1980s resulted in Ohio paying $263.7 million in interest.[37] Ohio's total interest on the advances taken in 2009 to 2014 totaled $257.7 million.[38]

FUTA prohibits a state from using its unemployment compensation fund, either directly or indirectly, to pay the interest. If the Secretary of Labor determines that any state action results in the direct or indirect payment of the advance through that state's unemployment compensation fund, the Secretary cannot certify the state as compliant. If a state system is not certified, the state's employers are not eligible to receive the credit on their FUTA taxes. Additionally, if a state does not make interest payments on a timely basis, the state may lose administrative funding and the employers may lose FUTA tax credit.[39]

Interest normally is due on the first day of the federal fiscal year (October 1). However, if an advance is made during the last five months of the federal fiscal year, a state need not pay interest on that advance before December 31. A governor must notify the Secretary if the governor decides to delay that payment.[40]

Additionally, in times of high unemployment for a state, the state may receive a deferral or delay on paying interest. If the Secretary determines that the average insured unemployment rate equals or exceeds 7.5% during the first six months of a calendar year, 75% of the interest due on October 1 of that year is deferred. A state must pay 25% of the interest due by October 1 of that year and must pay one-third of the deferred amount by October 1 in each of the next three years. A governor must apply to the Secretary by July 1 of the year the deferral is requested to receive a deferral. Interest does not accrue on the deferred interest.[41]

Similarly, if the Secretary determines, during the 12-month period preceding the October 1 when the interest normally is due, that the state had an average unemployment rate of 13.5% or greater, the state may delay the payment of interest for nine months. A delayed interest payment must be paid in full by the following July 1, and interest does not accrue on the delayed interest.[42]

If advances are not repaid within a certain time frame interest charges also accrue.

Restrictions on state activity

If a state has received a federal advance, the state is more restricted than usual when it comes to making changes to its unemployment compensation system. This is especially true if the state wishes to avoid or limit the tax credit reduction as described below. Essentially, a state cannot take any action, whether legislative, administrative, or judicial, that results in either (1) a reduction in the state's unemployment tax effort or (2) a decrease in the net solvency of its unemployment compensation system. The former actions include a reduction in the taxable wage base, the tax rate schedule, tax rates, or taxes payable, including surtaxes. The latter comprises actions that result in an increase in benefits without at least an equal increase in taxes, or a decrease in taxes without at least an equal decrease in benefits.[43]

Federal law severely restricts a state's freedom of action while it owes repayment for advances. A state may not make any changes to its unemployment compensation program that: (1) cause a net reduction in the state's tax effort, or (2) increase the net outflow of money from the state's fund.

Mitigating the employer FUTA tax credit reduction

FUTA allows a state to avoid or limit the reduction in employers' FUTA tax credit for failing timely to pay back an advance, if the state satisfies certain requirements. The requirements to cap the reduction include that the state did not take action during the 12-month period ending on September 30 of the taxable year that (1) has resulted or will result in a reduction in the state's unemployment tax effort and (2) that has resulted or will result in a net decrease in the solvency of the state unemployment compensation system. The cap in the reduction is in an amount that does not exceed the greater of the reduction of that credit that was in effect with respect to the state for the preceding taxable year, or 0.6% of the wages paid by the employer during that taxable year that are attributable to the state.[44]

Additionally, as discussed under "**Consequences of obtaining an advance**" above, an additional reduction in an employer's FUTA tax credit may be applied beginning the third consecutive year that an outstanding advance balance exists, with an even higher reduction (the BCR) applied beginning the fifth consecutive year that the balance exists. A state may apply for a waiver of the fifth-year credit reduction, which allows a state to revert back to the lower rate used in the third and fourth years. To qualify for this waiver, a state's governor must apply to the Secretary before July 1 of the year for which the waiver is requested and no action (legislative, judicial, or administrative) may be taken during the 12-month period ending September 30 of that year that would reduce the solvency of the state's system for the period ending September 30.[45]

Endnotes

[1] R.C. 4141.09.

[2] U.S. Department of Labor, *State Unemployment Insurance Trust Fund Solvency Report 2018*, https://oui.doleta.gov/unemploy/docs/trustFundSolvReport2019.pdf.

[3] Legislative Service Commission, "Greenbook: LSC Analysis of Enacted Budget: Department of Job and Family Services," https://www.lsc.ohio.gov/documents/budget/132/MainOperating/greenbook/JFS.PDF.

[4] Section 741.10 of H.B. 390 of the 131st General Assembly.

[5] By this the Department appears to mean that the state taxable wage base has remained constant; unemployment taxes have been imposed on an employee's first $9,000 in wages since 1995. S.B. 235 of the 131st General Assembly temporarily increased the taxable wage base from $9,000 to $9,500 for calendar years 2018 and 2019. The taxable wage base will decrease to $9,000 beginning in 2020. (R.C. 4141.01(G).)

[6] Gongwer News Service, Unemployment Compensation Trust Fund Going Broke, Officials Say, Volume 77, Report 115, Article 1, (June 13, 2008), available at http://www.gongwer-oh.com/.

[7] See, e.g., *Lawmakers Must Fix Unemployment Fund*, *The Columbus Dispatch*, (January 28, 2018) https://www.dispatch.com/opinion/20180129/editorial-lawmakers-must-fix-unemployment-fund.

[8] See *Chas. A. Steward Mach. Co. v. Davis*, 301 U.S. 548, 588-589 (1937).

[9] See *A.L.A. Schlecter Poultry Co. v. U.S.*, 295 U.S. 495 (1925).

[10] 26 United States Code (U.S.C.) 3301 *et seq*.

[11] U.S. Const., Art. I, and *Chas. A. Steward Mach. Co.* at 583.

[12] *Chas. A. Steward Mach. Co.* at 598.

[13] 26 U.S.C. 3301, 3302, and 3303 and 42 U.S.C. 501 *et seq*.

[14] 26 U.S.C. 3302 and 3304.

[15] R.C. Chapter 4141.

[16] R.C. 4141.24, 4141.241, 4141.242, and 4141.25.
[17] R.C. 4141.25.
[18] Ohio Department of Job and Family Services, Office of Unemployment Insurance Operations, *Contribution Rates*, http://jfs.ohio.gov/ouc/uctax/rates.stm.
[19] See 26 U.S.C. 3304, which requires a state to establish an unemployment compensation fund and to use that fund, with some exceptions, only for the purpose of paying unemployment benefits.
[20] See Ohio Bureau of Employment Services, "Trust Fund Adequacy" 50 (1989).
[21] H.B. 826 of the 118th General Assembly.
[22] For example, several court cases have interpreted that the Ohio constitutional provision that is the basis for Ohio's workers' compensation system and a provision in Ohio's Workers' Compensation Law that specifies how the assets of the State Insurance Fund may be allocated (Ohio Const., Art. II, Sec. 35 and R.C. 4123.30) suggest a constitutional basis for the prohibition against use of money in the State Insurance Fund for purposes other than providing compensation to employees and their dependents for death, injuries or occupational disease, occasioned in the course of employment (see *Thompson v. Industrial Commission*, 1 Ohio St.3d 244 (1982); *Corrugated Container v. Dickerson*, 171 Ohio St. 289 (1960); *Welsh v. Industrial Commission*, 136 Ohio St. 387 (1940)).
[23] *Shkurti v. Withrow*, 32 Ohio St.3d 424 (1987).
[24] 42 U.S.C. 1321; 20 Code of Federal Regulations (C.F.R.) 606.4; and R.C. 4141.43(F).
[25] 42 U.S.C. 1321(a)(1) and (a)(3)(A).
[26] 42 U.S.C. 1321(a)(2) and (b).
[27] 42 U.S.C. 1321(a)(3)(B) and (C).
[28] 42 U.S.C. 1322(a).
[29] 26 U.S.C. 3302(c)(2).
[30] 26 U.S.C. 3302(c)(2)(A)(ii) and (d)(1) and Ohio Bureau of Employment Services, "Trust Fund Adequacy" 49 (1989).
[31] 26 U.S.C. 3302(c)(2)(B) and (C).
[32] 42 U.S.C. 1101(d).
[33] 42 U.S.C. 1103.
[34] 26 U.S.C. 3301 and 3302 and U.S. Department of Labor, *Historical FUTA Credit Reductions*, https://oui.doleta.gov/unemploy/docs/reduced_credit_states_2009-2018.xlsx.
[35] 42 U.S.C. 1322. See also 20 C.F.R. 606.32.
[36] 42 U.S.C. 1322(b)(1).
[37] Ohio Bureau of Employment Services, "Trust Fund Adequacy" 50 (1989).
[38] Legislative Service Commission, "Greenbook: LSC Analysis of Enacted Budget: Department of Job and Family Services," https://www.lsc.ohio.gov/documents/budget/132/MainOperating/greenbook/JFS.PDF.
[39] 26 U.S.C. 3304(a)(17), 42 U.S.C. 503(c)(3) and 1322(b)(5), and R.C. 4141.09(G).
[40] 42 U.S.C. 1322(b)(3)(A) and (B) and 20 C.F.R. 606.40.
[41] 42 U.S.C. 1322(b)(3)(C) and 20 C.F.R. 606.41.
[42] 42 U.S.C. 1322(b)(9) and 20 C.F.R. 606.42.
[43] 20 C.F.R. 606.21.
[44] 26 U.S.C. 3302 and 20 C.F.R. 606.21 and 606.22.
[45] 26 U.S.C. 3302(c) and 20 C.F.R. 606.25 and 606.26.

Published by the Ohio Legislative Service Commission Staff

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