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The 2021-22 Budget:

Interest Payment on Federal Unemployment Insurance Loan

FEBRUARY 2021

Introduction

The California labor market collapsed in late March and early April due to the coronavirus disease 2019 (COVID-19) pandemic. By April, 2.6 million California workers were unemployed and therefore eligible for state unemployment insurance (UI) benefits. For comparison, during the Great Recession, the number of unemployed workers peaked at 1.3 million. Due to this unprecedented level of unemployment, the state's UI Trust Fund, which collects payroll taxes that fund UI benefits, became insolvent during the summer of 2020. To continue paying weekly UI benefits after the fund became insolvent, the state took on available federal loans. Under federal law, the state must make annual interest payments on outstanding loans until the loans are repaid.

Background

UI Program Assists Unemployed Workers. The UI program provides weekly benefits to workers who have lost their jobs through no fault of their own. The federal government oversees state UI programs but the state has significant discretion to set benefit and employer contribution levels. Under current state law, weekly UI benefit amounts are intended to replace up to 50 percent of a worker's prior earnings, up to a maximum of $450 per week, for up to 26 weeks. In 2019, the average benefit amount was $330 per week.

UI Program Is Financed With Payroll Taxes Paid by Employers. Employers pay both state and federal UI payroll taxes. State UI tax revenues are deposited into the state's UI trust fund to pay benefits to unemployed workers. State UI tax rates are set based on rate schedules laid out in state law. The schedules require higher rates, up to a maximum of 6.2 percent, when the condition of the UI trust fund is poor—meaning that it has a low level of reserves. Due to longstanding solvency issues, the state's UI tax rate has been at this maximum amount since 2004. When the trust fund reserve is larger, schedules with lower tax rates are in place. The federal UI tax is typically used to pay for state UI program administration costs and is set at a rate of 0.6 percent. Both state and federal UI payroll taxes are applied to each employee's first $7,000 in annual wages.

States May Borrow From Federal Government During Economic Downturns. During recessions, the state's UI trust fund can become insolvent as the cost of benefits exceed employer tax contributions and trust fund reserves are exhausted. Federal law allows states, when they exhaust their state UI trust funds, to receive loans from the federal government to continue paying benefits. These loans must be repaid, with interest (currently 2.3 percent annually), at a later time. The loan principal is repaid by automatic increases in the federal UI tax rate that are set out in federal law. The loan interest typically has been paid from states' General Funds.

California Has Received Substantial Federal Loans. California, like many other states, has used these federal loans to continue paying benefits during the pandemic. As of February 2021, the state has received $18.5 billion in federal UI loans to cover state UI benefit costs. (This state debt is only related to paying regular state UI benefits.

The state does not need to borrow to pay for the temporary benefit increases and extensions that the federal government enacted during the pandemic because these benefits are 100 percent federally funded.) California also received federal loans during the Great Recession. The state's peak year-end balance of loans was $10.2 billion at the end of 2012. Between 2011 and 2018, the state General Fund paid a total of $1.4 billion in interest payments on these loans.

Rarely Used Provision of Federal Law Allows States to Defer UI Interest Payments. Under federal law (42 United States Code Section 1322), states are eligible to delay upcoming interest payments on federal UI trust fund loans under certain circumstances. Specifically, if the average state unemployment rate exceeded 7.5 percent during the first six months of the prior calendar year (in this case, January through June 2020), the state may pay 25 percent of the interest due. The remainder (75 percent) would be repaid in three 25 percent portions over the next three years. Interest payments deferred under this provision do not accrue additional interest. To our knowledge, no state has ever used this provision to defer accrued interest payments, largely because the provision is not widely known. At our request, however, the administration received confirmation from the U.S. Department of Labor that California currently is eligible for this interest deferral.

Proposal

$555 Million Estimated General Fund Interest Payment. The *2021-22 Governor's Budget* proposes $555 million General Fund to make the first annual interest payment on federal UI trust fund loans received during the pandemic. (This amount corresponds to the full interest payment, not the 25 percent that would be due under the interest payment deferral discussed above.) The estimated interest payment is due September 30, 2021.

Analysis

$555 Million Interest Payment Estimate Based on Outdated Economic Forecast... The administration's interest payment estimate is based on underlying economic assumptions made by the Department of Finance in April, 2020. At that time, both the administration and our office estimated that the economic consequences of the pandemic would be severe and prolonged. Since then, the actual consequences have become clear and, though substantial, were not nearly as severe as we had anticipated. However, the administration's interest payment estimate is based on these outdated forecasts. Specifically, the estimate is based on the assumption that the average state unemployment rate in 2021 will be 18 percent. The state's current unemployment rate is about half that level. As a result, the $555 million interest payment is based on an implausibly large projection of outstanding federal loans at the end of 2021—$48 billion. Taking updated economic conditions into account, we believe the 2021 year-end federal loan balance is likely to be closer to $25 billion.

...Does Not Reflect Extended Interest Waiver Under Recent Federal Law. The federal Families First Coronavirus Response Act, enacted in March 2020 in response to the COVID-19 pandemic, allows states to waive interest accrued during calendar year 2020 on federal UI loans. The administration's interest payment estimate accounts for this waiver. However, after the administration developed its estimate, the federal government, on December 27, extended the interest accrual waiver from the end of 2020 through March 14, 2021. As a result, the state's interest payment for 2021-22 will cover roughly 6 months of accrued interest (March 15 through September 30), whereas the administration's interest payment estimate reflects

9 months of interest. The administration has stated that it plans to update their interest payment estimate as part of the May Revision to account for the recent federal law change.

As a Result, Governor's Budget Overstates Interest Payment by Roughly $300 Million. We estimate the state's first interest payment on federal UI loans will total roughly $260 million. This amount is roughly $300 million less than the amount estimated by the administration. This lower estimate reflects a lower projection of federal loans outstanding (based on current economic conditions) and a shorter interest accrual duration period (based on the recently extended waiver).

Recommendation

Adopt Updated $260 Million Estimate of Federal Interest Payment Due. We recommend the Legislature adopt an up-to-date estimate of the overall interest amount likely due in September. For planning purposes, we suggest the Legislature adopt our estimate of $260 million. This estimate reflects current economic conditions and federal law. If the federal government takes further action to extend the interest waiver beyond March 14, this estimate would need to be revisited and likely reduced accordingly. Mindful of this shifting landscape, the administration and our office will provide an updated estimate as part of the May Revision.

Defer Interest Until Later Years. In addition to adopting an up-to-date estimate of the total interest payment, we recommend the Legislature adopt provisional budget legislation to request an interest payment deferral from the U.S. Department of Labor, given that the deferral does not have the effect of increasing state payments. This would allow the state to pay one-quarter of this year's interest payment in 2021-22 and an additional one-quarter in each of the next three years. Should the Legislature pursue this course, we estimate that the total interest due this year would be roughly $65 million.

LAO Publications

This report was prepared by Chas Alamo, and reviewed by Brian Uhler and Carolyn Chu. The Legislative Analyst's Office (LAO) is a nonpartisan office that provides fiscal and policy information and advice to the Legislature.