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U.S. Bills States \$1.3 Billion in Interest Amid Tight Budgets

By MICHAEL COOPER and MARY WILLIAMS WALSH

As if states did not have enough on their plates getting their shaky finances in order, a new bill is coming due — from the federal government, which will charge them \$1.3 billion in interest this fall on the billions they have borrowed from Washington to pay unemployment benefits during the downturn.

The interest cost, which has been looming in plain sight without attracting much attention, represents only a sliver of the huge deficits most states will have to grapple with this year. But it comes as states are already cutting services, laying off employees and raising taxes. And it heralds a larger reckoning that many states will have to face before long: what to do about the \$41 billion they have borrowed from the federal government to help them pay benefits to millions of unemployed people, a debt that federal officials say could rise to \$80 billion.

The states, when they borrowed the money, hoped that the economy would have turned around by the time the first interest payments came due, or that future Congresses might loosen the terms. But the economy did not turn around in time and the new Congress, dominated by Republicans determined to shrink the size of government, shows little appetite for deepening the federal deficit by bailing out the states.

The problem is not only the staggering number of people who have lost their jobs, but the fact that many states entered the downturn with too little money salted away in the trust funds they use to pay unemployment benefits, which they are supposed to build up in good times by taxing employers.

Those anemic trust funds ran dry quickly in many states as millions of newly jobless Americans began collecting benefits. So many states borrowed money from the federal government, helped by the stimulus act, which gave them a break on interest for nearly two years. But that grace period ended Dec. 31, and states will owe the first interest on those loans in September.

Michigan, which owes Washington \$3.7 billion, is supposed to pay \$117 million in interest by September — just about what it pays each year to run Western Michigan University. California, which owes \$362 million in interest on a total debt of \$9.7 billion, the highest in the nation, plans to juggle its accounts, borrowing from a trust fund for disabled workers to pay interest to the federal government.

In New York, which owes \$115 million in interest on \$3.2 billion, the cost will be passed on to employers in the form of a tax surcharge. Texas went to the bond market and borrowed \$2 billion to pay back all the money it borrowed from the federal government, judging that the interest on the bonds, which are backed by a tax on employers, would cost less.

Some states are planning to follow the lead of Texas, and borrow the money to repay the federal government. Others are asking for more time.

“During this time of extreme economic stress not only on the citizens of our states, but also on state budgets, state loan interest payments that will come due in September 2011 place further hardship on states’ finances and could slow economic recovery,” a group of 14 governors from both parties wrote to Congressional leaders last month. Their letter added: “Extending the interest-free loans would allow states to avoid increasing payroll taxes, reducing benefits, or both, while the economic recovery continues.”

Many advocates believe that the new Republican majority in Congress, which has said it plans to focus

on deficit reduction, may be hesitant to postpone collecting the interest. But they could face pressure from newly elected Republican governors in states like Michigan, Ohio, which owes \$2.3 billion, and Florida, which owes \$2 billion.

The effects of the problem are already being felt. While states are generally loath to increase taxes on businesses during a **recession**, for fear that it can discourage much-needed hiring, 35 states were forced to raise their state unemployment taxes on employers in 2010, according to a survey by the National Association of State Workforce Agencies.

If states are unable to repay their outstanding federal loans by November — which will prove difficult for many — nearly half the states could be forced to effectively raise federal taxes on employers by about \$21 per worker, under a provision of federal law that automatically reduces the tax credits given to businesses in states that carry loans two years in a row. Businesses in Michigan, Indiana and South Carolina are already paying the higher federal tax.

But even with those effective federal tax increases, which would continue to rise each year the loan is not repaid, it could take years for some states to repay what they have borrowed.

“This is a problem that’s going to persist because of the structural imbalances in the way this system is financed,” said Patrick T. Beaty, a deputy secretary of the Pennsylvania Department of Labor and Industry, who explained that Pennsylvania’s unemployment tax base had not kept up with the rising cost of the benefits, leading to a chronic insolvency.

“Unless that’s corrected, these loans are going to go on for years, even if the economy improves,” he said.

Pennsylvania, one of a handful of states that make both workers and employers pay into its unemployment program, is activating a dormant state “interest tax” to pay the \$102 million it expects to owe the federal government this year. It owes Washington \$3.1 billion, and officials expect the debt to grow to \$3.7 billion by the end of the year. Even with the rising federal tax on employers each year,

Mr. Beaty said, Pennsylvania could end up owing the federal government \$4.3 billion eight years from now.

The state debts are the highest they have been in the 75-year history of the nation's unemployment program. They are unrelated to the extra weeks of unemployment benefits that Congress agreed to pay for in the stimulus, and then extended late last year as part of the tax cut compromise — those extended weeks are paid for with federal money. The borrowing that many states were forced to do was in order to simply continue paying their basic unemployment benefits, which generally last up to 26 weeks.

The last time state borrowing even approached this level was after the recession of the early 1980s. It took years for many states to repay the debts then, and sparked states to raise taxes on businesses, reduce benefits for the unemployed and borrow money on the bond market — a range of unappealing options for distressed states during a downturn.

Right now, 30 states owe money to the federal government for their unemployment programs. Many of them tried to keep their unemployment taxes low in recent decades as states have competed with one another to lure companies and jobs. Now, although unemployment taxes are low by historic standards, the states face the strong possibility that they will have to take action at the worst possible time, raising taxes on employers at a time of low hiring, and cutting benefits when they are most needed.

States are beginning to try to deal with the short-term problem.

In West Virginia, which has not had to borrow unemployment money from the federal government, Gov. Earl Ray Tomblin, a Democrat, used his state of the state speech last week to call for propping up the state's unemployment reserves with \$20 million from its rainy day fund. And a bill was introduced in Arizona this month that would temporarily raise taxes on employers to repay both the principal and interest of the \$258 million the state has had to borrow so far. One of the bill's sponsors, State Representative Bob Robson, a Republican representing Chandler, said that many businesses understand the need to take action.

“They recognize that this needs to be done,” he said in an interview, “or the cost would be more prohibitive in the future.”



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