

Projected \$27.3 Billion UI Fund Deficit by 2012 Could Lead to Higher Taxes on Employers

Background

California's unemployment insurance (UI) program is a federal-state program, completely funded by taxes on employers, that was created as part of the Social Security Act in 1935. The state of California administers a separate UI program within the guidelines established under federal law. The program provides weekly UI payments for workers who lose their jobs through no fault of their own and meet other eligibility requirements imposed by the state of California. UI benefits act as a stabilizer during economic downturns by being the primary source of temporary, partial wage replacement for workers who have been laid off and are seeking re-entry into the workforce.

California employers pay taxes on the first \$7,000 in wages paid to each employee. The tax rate that employers pay varies based in part on the amount of benefits that have been paid to former employees. During good economic times employers that have fewer claims are rewarded with a lower tax rate. Because the UI Trust Fund is facing financial difficulties, all employers in California are paying taxes under the highest schedule allowable under state law, plus a 15 percent solvency surcharge.

A portion of the employer's tax goes directly to the federal government and is used to fund administration of benefits on the state level, pay for a portion of extended duration benefits and provide a fund from which states can borrow if necessary to pay benefits. The larger portion goes into a special UI Trust Fund used to make benefit payments to unemployed workers. California employers have paid nearly \$25 billion in UI taxes since 2006, with \$4.9 billion paid in 2008 alone.

California has the largest UI system in the country. According to the U.S. Department of Labor, the California UI system provides the easiest access to benefits; covers more workers—including part-time workers; pays more claims; and pays more weeks of benefits than any other state in the nation. Other states may have a higher UI weekly wage replacement, but most of them require a much stronger attachment to the labor force by requiring a longer time on the job and greater earnings before a worker becomes eligible for the benefits. This means that fewer people qualify for benefits in other states, but they are paid more generously. California policymakers have made a decision to provide lenient eligibility standards, which makes it impossible to responsibly provide higher benefits.

Dramatic Rise in Unemployment

California's unemployment rate has increased steadily over the last several years, with a significant increase in the ranks of the unemployed since 2008. In September 2008, California had an unemployment rate of 7.6 percent, which meant that California was paying benefits to 1.399 million out-of-work Californians. By September 2009, California had added nearly 1 million people to the ranks

California Suffers Sharp Increase in Unemployment

Category	September 2009 (Preliminary)	August 2009 (Revised)	July 2009	September 2008
Civilian Labor Force	18,365,000	18,512,000	18,600,000	18,467,000
Total Civilian Employment	16,164,000	16,254,000	16,346,000	17,068,000
Unemployment	2,201,000	2,258,000	2,254,000	1,399,000
Unadjusted Rate	12%	12.2%	12.1%	7.6%

Source: California Employment Development Department

of the unemployed, resulting in an unemployment rate of 12 percent. According to the U.S. Bureau of Labor Statistics, California has the fourth highest unemployment rate in the nation.

While the sheer numbers of unemployed Californians is problematic, the speed at which the ranks of the unemployed have grown has been especially concerning. In August 2008 alone, there was a 61,000-person increase in the number of unemployed Californians. The August increase was the state's fourth increase of 60,000 or more in 2008, but just the fifth since 1976. These sizable increases in the number of unemployed Californians continued through 2009.

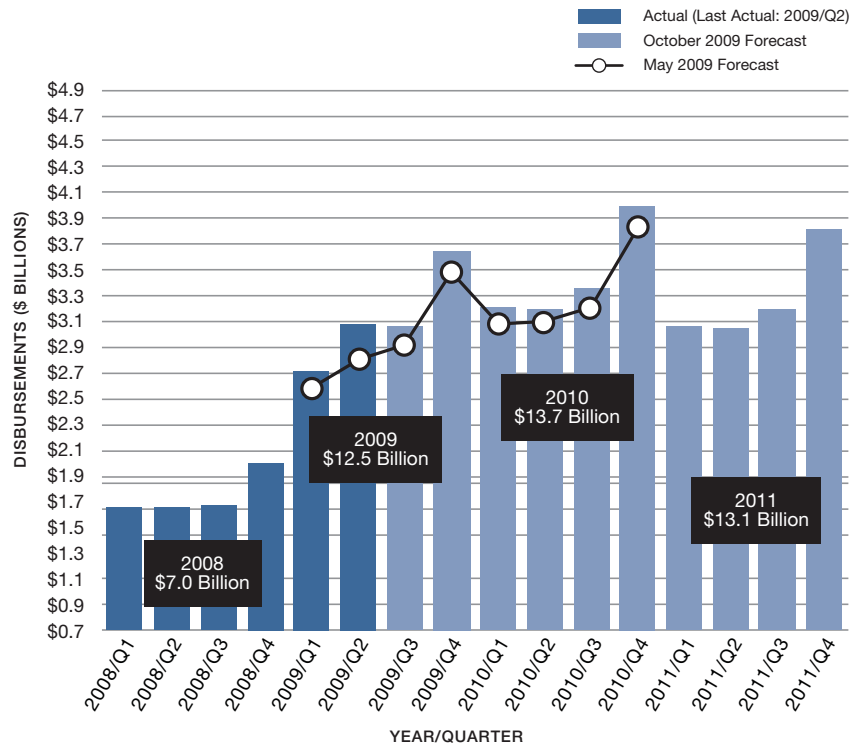
The large increases in the ranks of the unemployed, coupled with benefit increases over the last decade, have led to a dramatic increase in expenditures from the UI fund. In fact, California paid more benefits to unemployed workers in 2008 than in 2006 and 2007 combined. According to the Employment Development Department (EDD), California's UI fund paid more than \$9.1 billion in benefits during the 2008 state fiscal year. This compares with a combined \$8.9 billion paid during the 2006 (approximately \$4.4 billion) and 2007 (approximately \$4.5 billion) state fiscal years.

The increase in benefits paid to unemployed Californians will continue for the foreseeable future, according to EDD's analysis. EDD's October 2009 *Unemployment Insurance Fund Forecast* estimates that California will have a benefit disbursement of \$12.5 billion in 2009, \$13.7 billion in 2010, and \$13.1 billion in 2011.

UI Fund Insolvency

California, like 25 other states and territories, is struggling with a UI Trust Fund insolvency resulting from sudden and severe increases in unemployment associated with the worldwide recession. California's UI Trust Fund technically became insolvent in January 2009, and by November 2009 the state had borrowed more than \$5.5 billion from the Federal Unemployment Account (FUA), which is funded by employers, in order to pay benefits to California's unemployed. Although California has taken the largest loan from the FUA, there are a total of eight

Regular UI Benefits Disbursements 2008–2011



Source: California Employment Development Department

states with loans exceeding \$1 billion.

California's current UI fund insolvency is not caused only by immense unemployment, but also can be traced back to the UI benefit increases imposed in 2001. The California Chamber of Commerce opposed this increase in benefits because it was not coupled with cost-saving reforms and therefore was likely to lead to UI fund insolvency.

As anticipated by the CalChamber in 2001, benefit increases along with high unemployment have led to insolvency for the UI fund. Further exacerbating the situation, as unemployment and duration of benefits increase, the state is collecting fewer tax revenues and paying more benefits to unemployed Californians.

With annual UI benefit obligations rising to more than \$13 billion and annual UI tax receipts peaking at just more than \$5.6 billion, California can expect its UI fund to continue taking \$8 billion or more in loans each year from

the FUA. In fact, EDD has projected that the current unemployment rate and benefit levels will result in a UI fund deficit of \$27.3 billion by the end of 2011. All this money will have to be borrowed from the FUA and repaid. If California does not have sufficient UI tax receipts to both pay ongoing benefits and repay the FUA loan, however, the debt will remain outstanding and the state will have to pay interest on the principal beginning in 2011.

The federal government does have the power to impose small annual increases in the federal UI assessment on employers in California if the loan is not paid back in a timely fashion. The federal government's ability to increase taxes on California employers in this scenario, however, is limited under federal law. The increase would be temporary and would go directly to paying down the principal of the loan. With a loan as substantial as California's, this federal tax increase mechanism would be incapable of

extracting sufficient tax revenues to repay the loan in a timely fashion.

Any interest charged by the federal government on the loan balance could not be paid from the UI tax and would have to come from a different funding source, as the UI fund is reserved for benefit payments. One possible source for funds to pay the interest would be the tax that employers pay to fund the state Employment Training Panel (ETP). The ETP provides grants to businesses to strengthen their workforces through job training. Over the last several years, the state of California has diverted hundreds of millions of ETP dollars to other state programs. The program serves both to train existing California employees and to attract new jobs to California.

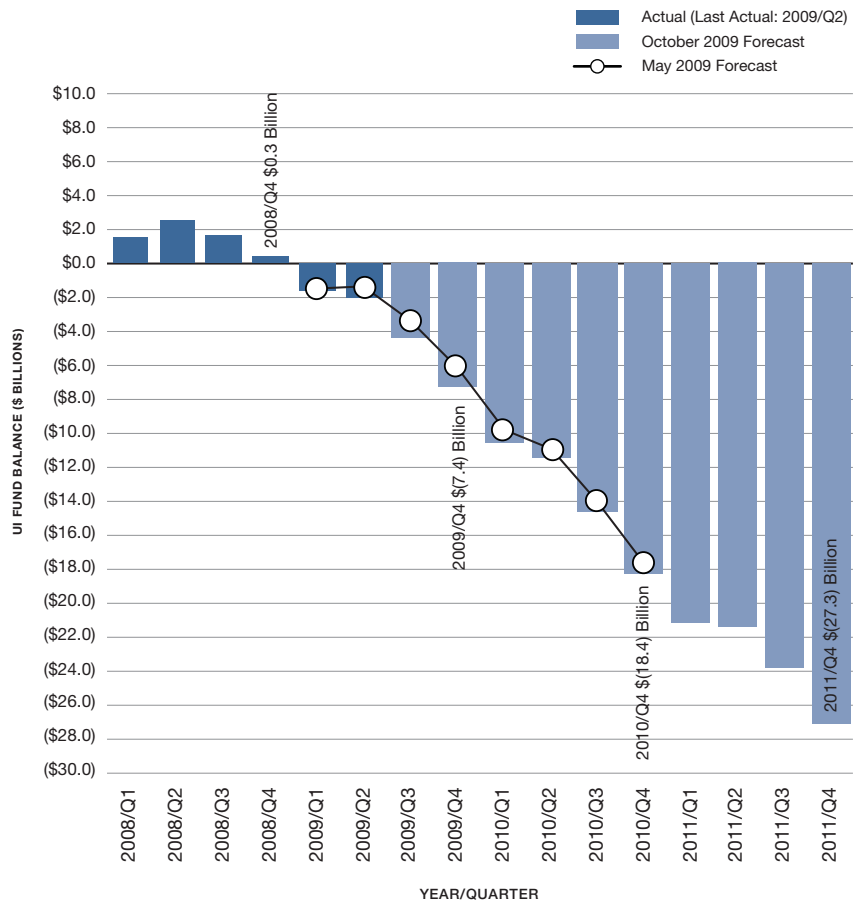
UI Tax Policy in 2009

Two major pieces of legislation introduced in 2009 and still viable in this session would have significantly increased UI taxes on California employers. AB 1298 (Coto; D-San Jose and Arambula; I-Fresno) and SB 222 (Ducheny; D-San Diego) seek to increase the UI tax on employers in an attempt to address the UI fund insolvency.

AB 1298 increased the maximum UI tax rate in California from 5.4 percent to 7.5 percent. This higher tax rate would then be applied to an increased taxable wage base. Specifically, AB 1298 increases the taxable wage base in California from \$7,000 to \$16,600. At press time, SB 222 does not increase the UI tax rate, but instead triples the taxable wage base to \$21,000. The net result of both pieces of legislation would be significant increases in UI tax obligations for all California employers.

The rationale for these tax increases is that California employers enjoy a relatively low UI tax obligation when compared to employers in other states. Proponents of this position claim that California's taxable wage base of \$7,000 and tax rate of 5.4 percent are well below the national average. The belief is that this seemingly low tax obligation is the primary contributing factor to insolvency. The analysis that led to these assumptions is critically flawed, however. Proponents of tax increases compared only the statutory maximum tax rates when comparing UI

Unemployment Insurance Fund Balance 2008–2011



Source: California Employment Development Department

tax obligations by state.

When the actual dollars paid by employers are used for comparison, the UI tax obligation for California employers is actually above the national average. Federal UI tax data clearly shows that most states do not actually apply a UI tax rate near their statutory maximums when assessing employers.

When California's actual average UI tax rate is applied to the taxable wage base and then compared to other states, California employers actually have a moderately high tax obligation per employee. This analysis significantly undermines the position that California's UI fund insolvency is caused primarily by a low UI tax obligation for employers.

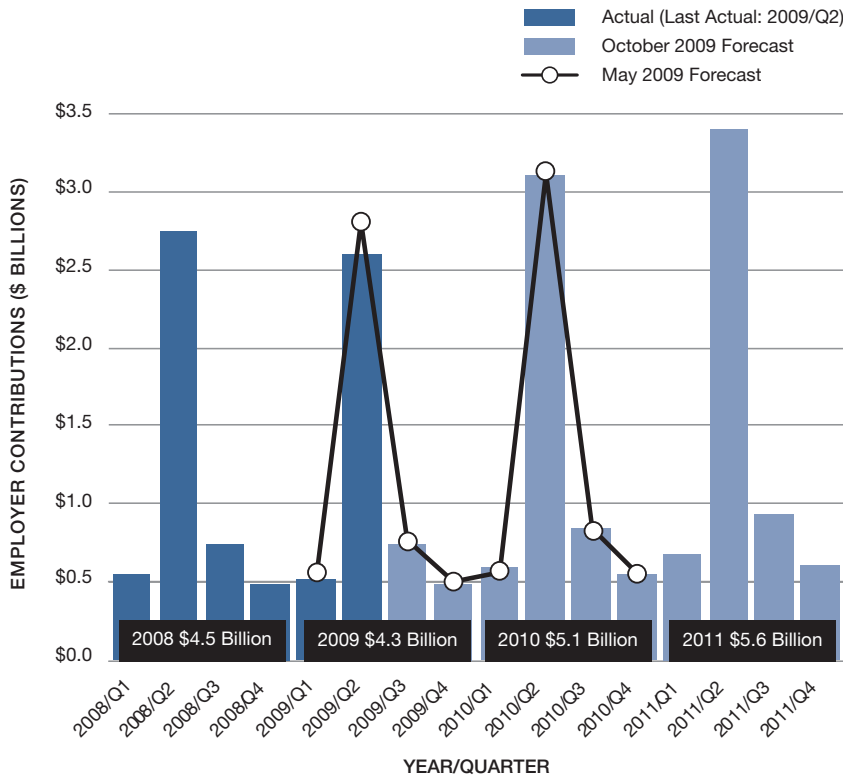
With traditional assumptions about

UI tax policy in question, the California EDD worked with stakeholders to craft an in-depth study of California's UI tax system and benefit structure. The purpose of the study was to more accurately compare California's system against other state UI systems so that policymakers could craft more appropriate solutions to the insolvency. The final report has been completed and has not yet resulted in any new policy recommendations.

UI Policy in 2010 and Beyond

The UI situation in California and across the nation is not likely to stabilize in 2010. Although the growth in unemployment is likely to slow throughout 2010, the California UI fund will continue to be stressed. Californians are staying unemployed

Employer Contributions 2008–2011



Source: California Employment Development Department

longer and receiving more benefits than they have in the past.

While the federal government has provided for extended duration benefits twice in the past year, there is still a mounting toll on California's UI fund. These benefits are funded partially by employer contributions to the FUA and partially by state UI funds. Ultimately, the entire bill lands on employers.

With EDD projecting a UI fund debt of \$27.3 billion by the end of 2011, it is likely that the California Legislature will again examine the potential for UI tax increases on California employers. This is especially true because California's continuing deficits could be exacerbated because of the UI fund insolvency.

Although the federal government has waived both the accrual and payment of interest through the end of 2010, the FUA loan will result in interest coming due in 2011. This interest cannot be paid out of California's UI Trust Fund, which is reserved for benefit payments. Instead, the money would have to come from California's General Fund.

The 2008 interest rate on FUA loans was 4.8 percent. If this interest rate were applied to a \$27.3 billion loan, the California General Fund would be on the hook for \$1.3 billion in interest. If California's FUA loan were projected to grow past 2011, which is likely, this interest burden on the General Fund

could grow. With this type of budgetary pressure applied to the Legislature, the idea of UI tax increases for employers could gain traction.

CalChamber Position

The CalChamber believes that the best way for California to combat rising unemployment, and therefore improve the stability of the UI Trust Fund, is to improve the business climate in California. California ranked as the sixth worst business climate in the United States in the Milken Institute's 2007 *Cost-of-Doing-Business Index*. According to that analysis, California has a cost of doing business that is 22.9 percent higher than the average state.

The California Legislature has made a series of public policy choices that has led to California having a high cost of wages, a high tax burden, excessive power costs and expensive commercial property. Any "fix" for the UI fund has to include a series of policy changes that will improve California's business climate and spur investment and job creation.



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