

Projected \$10.7 Billion UI Fund Deficit by 2013 Could Lead to Higher State Taxes on Employers

Background

Through federal and state cooperation, unemployment insurance (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 looking for employment. To induce states to enact UI laws, the Social Security Act of 1935 provided a tax offset incentive and authorized grants to states to meet the costs of administering the state systems. Employers receive an offset against federal taxes if state UI programs meet certain requirements.

Aside from federal standards, each state has major responsibility for the content and development of its UI law. The state itself decides the amount and duration of benefits (except for certain federal requirements concerning federal-state Extended Benefits); the contribution rates for employers (with limitations); and, in general, the eligibility requirements and disqualification provisions to collect benefits. The states also directly administer the programs collecting payroll taxes, maintaining wage records, taking claims, determining eligibility, and paying benefits to unemployed workers.

One federal requirement is that all contributions collected under state laws be deposited in the unemployment trust fund (UI Trust Fund) of the U.S. Treasury Department. States withdraw money from their account in the trust fund exclusively to pay UI benefits. Private plans cannot be substituted for the state plan.

Funded by Taxes on Employers

Other than federal grants for administration and certain extended benefits, California's UI program is funded exclusively from taxes on employers. The state of California administers its UI program through the Employment Development Department (EDD) 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.

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.

According to a report by the state Legislative Analyst's Office in October 2011, California's UI program, compared to other states, pays lower weekly benefits, but pays these weekly benefits for a longer duration and to a larger caseload. As a result, California, has comparatively higher total program costs. California's comparatively high cost structure could be mitigated by changing its policies for UI eligibility and benefits duration. Regardless of UI policies, however, California's UI program is likely to have a higher UI cost structure than the average U.S. state as a result of its comparatively worse labor market.*

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 longer periods of 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 the weekly payout is higher.

California employers pay taxes on the first \$7,000 in wages paid to each employee. Each employer pays a tax rate 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 has been facing financial difficulties for some time,

*California Legislative Analyst's Office, *California's Unemployment Insurance Program: Gaining Insight Through Comparison to Other States* (October 13, 2011).

all employers in California are paying taxes under the highest schedule rate allowable under state law, plus a 15% solvency surcharge.

Unemployment Levels Remain High

California's unemployment rate has increased steadily since 2008. In September 2008, California had an unemployment rate of 7.6%, which meant that California was paying benefits to 1.399 million out-of-work Californians. By September 2011, California reached an unemployment rate of 12.1%, dipping down to 11.7% in October, still significantly higher than the national unemployment rate of 9.1%. According to the U.S. Bureau of Labor Statistics, California has the second highest unemployment rate in the nation, behind only Nevada.

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 Trust Fund. In fact, California paid more benefits to unemployed workers in 2008 than in 2006 and 2007 combined. According to the EDD, California's UI fund paid more than \$9.1 billion in benefits in 2008, increasing dramatically to \$11.3 billion paid out in 2009. 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. Between 2009 and 2010, California employers paid more than \$10 billion in UI taxes and are projected to pay an additional \$10.9 billion between 2011 and 2012. Since 2001, California's total benefit costs have exceeded its revenue in all but two years.

In 2011, the state UI fund will have disbursed \$7.3 billion in benefits. According to EDD forecasts, benefits paid to unemployed Californians will decline over the next few years. In the October 2011 issue of *Unemployment Insurance Fund Forecast*, the EDD forecasts a decline in unemployment in the state over the next few years, resulting in benefit disbursements declining to \$7 billion in 2012, and \$6.3 billion in 2013—significantly less than earlier EDD forecasts.

UI Fund Insolvency

California, like 34 other states and territories (up from 32 in 2010 and 25 in 2009), 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) in order to pay benefits to California's unemployed. As of August 2011, outstanding loans to 32 states totaled \$36 billion, with California comprising more than 20% of the total. As of November 2011, California's outstanding federal loan was just more

than \$9.1 billion, almost \$6 billion more than the next highest state loan. Although California has taken the largest loan, there are a total of 11 states (up from eight states in 2009) with loans exceeding \$1 billion. According to the state Legislative Analyst's Office, absent any corrective action, California is expected to continue borrowing for the remainder of the decade. Continual borrowing has serious consequences for the state, particularly in the form of ongoing interest payments and increases in the effective federal unemployment tax rate on California employers.

Insolvency Factor

California's current UI fund insolvency is not only caused by significant 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-savings.

Benefit increases along with high unemployment have led to insolvency for the UI Trust 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 projected to be around \$7 billion this year, California can expect its UI Trust Fund to be in debt almost \$11 billion to the FUA by the end of 2012. If California does not have sufficient UI tax receipts to both pay ongoing benefits and repay the FUA loan, the principal debt will remain outstanding and the state will continue to pay interest on the balance.

The first annual interest payment on the FUA loan was slightly more than \$303.4 million, which was paid in September 2011. Federal law prohibits the payment of interest from the UI Trust Fund. Therefore, given the dire state of California's budget, the interest payment was paid for with a loan from the State Disability Insurance account, and will be paid back with interest from the General Fund.

Reduced Tax Offsets

Essentially a tax increase, federal statute requires the federal government to incrementally reduce the tax offsets on states that do not timely repay their FUA loans. A federal tax is levied on employers at a current rate of 6% on wages up to \$7,000 a year. The law, however, provides an offset credit against federal tax liability of up to 5.4% to employers who pay state UI taxes timely in states that do not have outstanding FUA loans. This credit is allowed regardless of the amount of the tax paid to the state by the employer. Accordingly, in states meeting the specified requirements, employers pay an effective federal tax rate of 0.6%, or a maximum \$56 per covered employee, per year. States that have outstanding FUA loans lose 0.3% of that offset each year that the principal remains outstanding, which amounts to an increase of \$21 per employee in federal UI payroll taxes for employers. Employers in states

continuing with outstanding loans lose 0.3% more of the offset credit each year (that is, in 2013 the tax increase would be \$42 per employee). The increase would go directly to paying down the principal of the loan. In the meantime, states must pay interest on outstanding loan balances from sources other than the UI Trust Fund.

2011 Congressional Activity

As a result of a series of federal extended benefit laws enacted since 2008 that now provide up to 73 weeks of federal benefits, the maximum number of weeks of unemployment benefits payable per person has grown to a record 99 weeks, which is currently available in 21 states with especially high unemployment rates, including California. Since mid-2008, \$180 billion in federal extended unemployment benefits have been paid, with most supported by federal general revenues.

During 2011, several proposals circulated throughout the year in Congress as well as a proposal from the President to address the solvency problem nationally. No specific action was taken to provide relief to states from their debts to the FUA, however. Insiders speculate that congressional action is not likely in 2012 on the matter. Following is an overview of the reforms that have been considered.

In early 2011, President Barack Obama's budget submission for the 2012 fiscal year was officially released. The proposal provided for **short-term relief from interest on loans** to states to pay benefits and delayed Federal Unemployment Tax Act (FUTA) offset credit penalties for two years. The short-term interest relief was estimated to be \$1.22 billion for 2011 and \$1.79 billion for 2012. The FUTA relief was estimated to be \$2.14 billion that would otherwise be paid in 2012 and \$4.54 billion for 2013. Both of these items were part of the request for relief from a broad-based employer coalition, of which the CalChamber is a member.

The budget also proposed the extension of the 0.2% FUTA surtax for the balance of 2011, 2012 and 2013 (this surtax expired in July 2011), and beginning in 2014 reduced the FUTA tax rate, but **increased the FUTA tax base** from \$7,000 to \$15,000 **with a permanent indexing of the FUTA tax base** to growth in wages. The combination of short-term relief with increasing and indexing the tax base and modifying the FUTA tax rate would have cost employers a net \$58.5 billion in payroll taxes over 10 years. The majority party in the U.S. House of Representatives is not expected to agree to a tax increase on employers. It is possible, however, that the tax increase could appear as a proposed tax extender in end-of-year legislation as an offset for increased spending in other areas.

The **American Jobs Act**, also introduced by President Obama in 2011, included a provision to extend the deadline to file for federal unemployment benefits in 2012. This plan would have extended the availability of up to 99

weeks of total unemployment benefits through the 2012 calendar year. On October 10, 2011, the U.S. Senate failed to garner enough votes to pass the bill. Although many Washington observers say the administration's jobs bill is dead in the water, it's possible that the unemployment extension could be separated and sent through on its own, or as part of another bill. The extension is estimated to cost \$44 billion, according to the Congressional Budget Office.

In October 2011, President Obama signed H.R. 2832 into law as a companion to the U.S.-South Korea Free Trade Agreement legislation and included an **extension of Trade Adjustment Assistance (TAA)**. The White House had insisted that TAA be extended as a condition of its moving ahead with the trade agreements, and included a number of amendments to UI designed to offset (pay for) the increased spending. Unfortunately, one of the TAA UI Offset amendments imposes increased costs on employers and state UI agencies, and was not deleted from the bill as requested by a large group of state business associations, including the CalChamber.

The **UI Offset provision** of the TAA requires states to adopt laws to penalize employers when they are not able to provide "adequate and timely" information as determined by the state UI agency. This offset provision adds federally dictated unnecessary reporting burdens for employers, and increases administrative costs for state UI administrative agencies. The provision could result in employer accounts not receiving relief from charges even when individuals admittedly should not have been paid benefits. Employers already have an incentive to report employment information as quickly and adequately as possible, namely that failure to report is more likely to result in the claimant being paid and the employer's account charged for benefits.

Also in 2011, the House Republicans introduced the **JOBS Act of 2011**. This bill would have permitted the FUTA 0.2% surtax to sunset in 2011 and would have granted states increased flexibility in spending FUA funds currently allocated to administration of the program. The amount could have been used by states to pay for principal and interest on FUA loans, or to provide assistance to unemployed workers in finding employment. The bill also would have codified the basic requirement of the UI program that individuals must be able to work and actively seeking work as a condition of being paid unemployment benefits. The JOBS Act of 2011 passed the House Ways and Means Committee on a party-line vote, but was not taken up on the floor.

In late 2011, House Democrats introduced the **Emergency Unemployment Compensation Act** to extend federally funded UI benefits through 2012. Among the bill's provisions is short-term relief for states from interest on federal UI loans and from higher unemployment taxes on employers (loss of the 0.3% offset credit) if specific

criteria are met. In order for states to be eligible for relief, they would be required to maintain the amount, duration and access to UI benefits as they are today. As of publication, an extension is in place through February 2012 while Congress negotiates a longer-term solution. No relief for states' interest or relief from taxes on employers was included in this short-term stop-gap measure.

UI Policy Outlook for 2012 and Beyond

The UI situation in California and across the nation is not likely to stabilize in 2012. Unemployment levels have continued to remain high in California and will likely continue so through 2012. With the EDD projecting a UI Trust Fund debt of \$10.7 billion by the end of 2012, 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. In spite of an earlier report of the state Legislative Analyst's Office that suggested that options involving UI tax increases on employers would quickly improve the fund condition, the report also concludes that tax increases could hurt California's competitiveness. Furthermore, the report concludes that decreasing UI benefits alone would not resolve fund solvency.

Flawed Analysis

Proponents' argument for a tax increase 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% are well below the national average. California's tax rate is about average compared to other states, however. 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. On the contrary, employer taxes are about the same for solvent states and insolvent states, so the tax rate is not a determining factor. Rather, both the size of the labor force and the number of employers is a more significant difference between solvent and insolvent states. Both the size of the labor force and the number of employers are significantly smaller in solvent states, on average.

The state Legislative Analyst's Office analysis suggests that a portion of California's high costs can be attributed to UI policies. However, it appears that a significant portion is attributable to other factors, such as consistently higher unemployment rates and longer average spells of unemployment, compared to other states. Absent significant improvements to California's economy, the state will continue to maintain a structural mismatch between revenues derived from a strong economy and total benefit costs incurred in a recession in the out years.

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*. California's business climate continued its decline to be one of the worst, as indicated by several indicators: the Council on State Taxation reported in its *Business Tax Burden Study* that California's corporate income tax rate is double the national average; the Tax Foundation's *2011 State Business Tax Climate Index* ranked California 49; Forbes' *2010 Best States for Business* ranked California 38 overall, and 44 for business costs; and in *CEO Magazine's Best and Worst States for Business*, for the third straight year, California came in last (51). The Small Business and Entrepreneurship Council, for the last four years, has ranked California at 48 or 49 among the states for its costs and burdens of government on small businesses.

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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