California's Unemployment Insurance Trust Fund Is at Risk of Insolvency

August 2003

Introduction

California's unemployment insurance (UI) trust fund balance is rapidly diminishing and faces prospects of future insolvency. This briefing paper – an update of a 1998 report[1] by the Senate Office of Research (SOR) – explores issues related to UI trust fund solvency along with options for restoring stable financing to the state's UI program.

SOR's earlier report highlighted the low levels of UI benefits, relative to other states, paid to California's unemployed and the problems faced by the state's financing system. Since then, Senate Bill 40 (Alarcon) has been enacted to phase in a series of benefit increases through January 2005.[2] Last year's increase moved California from last in the nation in terms of the percentage of wages replaced by UI benefits to 48th in the nation. (See Appendix #1.)

California's average weekly benefit continues to fall well below the national average and ranks 37th in the nation. (See Appendix #2.) However, as the bill's benefit increases are fully phased-in, California's wage replacement rate and average weekly benefit should move closer to the national average.

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1 Sherriff, Rona Levine, *Financing Unemployment Insurance: Protecting California's Jobless Workers and Employers in a Changing Economy,* Senate Office of Research, Sacramento, CA: September 1998. <www.sen.ca.gov/sor/reports/reports_by_subj/economy_employment/unemploy.htm>

2 Senate Bill 40 (Alarcón), Chapter 409, Statutes of 2001, increased maximum weekly UI benefits for the first time in a decade from $230 to $330 beginning January 1, 2002, and to $370 on January 1, 2003. The maximum will increase to $410 on January 1, 2004, and to $450 as of January 1, 2005.

While improvements to the UI benefit structure will increase the level of benefits paid to the unemployed, the program's financing has not kept pace with growth in wages and other changes in the labor market. Without fixing the financing provisions of the UI program, it will not provide stability for the employers who finance this system and for the unemployed workers who rely upon it to sustain themselves during periods of unemployment.

Background

The Social Security Act of 1935 created a unique federal-state UI partnership designed to lessen the financial hardships of joblessness while helping to stabilize local economies. By partially replacing lost wages, UI benefits have allowed jobless workers to continue paying for food, clothing and shelter while they seek new work. These resources, in turn, are invested in local economies and help communities through periods of economic downturn.

Federal law provides the guidelines for the program, while each state designs its own eligibility, financing and coverage provisions. Federal taxes imposed on employers under the Federal Unemployment Tax Act (FUTA) pay for administering the states' UI and employment services programs. Employers pay a federal payroll tax of 6.2 percent on the first $7,000 they pay annually to each worker. However, this tax is reduced by a 5.4 percent federal offset credit to only 0.8 percent – or a maximum of $56 per employee – if a state's laws conform with federal requirements for operating UI systems.

Benefits are financed through state employer payroll taxes that are held in UI trust fund accounts in the federal treasury. There are two ways a state can finance its UI system: counter-cyclical or pay-as-you-go:

- *Counter-cyclical* – During periods of economic prosperity, employers pay into the UI trust fund at levels that will support UI benefit payments during a prolonged downturn in the economy. This method of forward funding is designed to assure adequate solvency to cover benefits during recessions.

- *Pay-as-You-Go* – This approach avoids the accumulation of large excess reserve accounts, but requires employers to substantially increase their contributions during periods of recession, when they can usually least afford it.

For decades, UI systems in the United States were counter-cyclical. However, since the mid-1980s, some states including California have moved toward pay-as-you-go models.

Evaluating Trust Fund Solvency

UI fund solvency is measured by evaluating the number of years a state's trust fund would be able to pay benefits with no additional revenue. This measurement tool is called the Average High Cost Multiple (AHCM) and is based upon the average of a state's three historically highest-cost years. The Department of Labor recommends an AHCM of 1.0, meaning a fund could pay out benefits for a year without increased revenues.

In 2002, California' AHCM was .52, which suggests the state could pay out only six months worth of benefits without additional revenue. This was down from an AHCM of 1.11 in 1980, a change that coincides with California's move toward a pay-as-you-go model. (Appendix #3 provides a state-by-state comparison of AHCMs.)

Data released by the U.S. Department of Labor (DOL) and the state Employment Development Department (EDD) point to decreasing fund balances in California and insolvency in 2004. EDD is required by statute[3] to submit a report on the status of the Unemployment Fund to the Legislature on May and October of each year. The May 2003, report which is based on data through December 2002, projects that disbursements will exceed revenues in calendar years 2002, 2003 and 2004 and that the fund will sink into insolvency in early 2004.

Projected Status of the Unemployment Fund in California
(in billions)

Calendar Year	Employer Contributions	Disbursements	Year-End Trust Fund Balance
2002	$2.6	$6.0	$3.56
2003	3.3	6.8	.43
2004	5.1	7.0	-1.17

Source: EDD's UI Fund Forecast, July, 2003

[3] California Unemployment Insurance Code, Section 995.

What Happens When a State UI Trust Fund Becomes Insolvent?

States are legally obligated by federal law to pay UI benefits. When a state trust fund is unable to pay benefits, a state must either borrow from a federal government loan fund or seek private financing.

If a state requests and receives a loan from the U.S. Department of Labor, the loan must be repaid with interest.[4] The loan principle (but not interest) may be paid from the state's UI trust fund, which requires generating additional state revenue for the fund. If a loan is not repaid within a specified period, the federal unemployment tax on employers increases.[5]

Interest payments may *not* be made by diverting some part of the state's UI taxes but can come from other existing tax revenues – such as EDD's Contingent Fund, EDD's Benefit Audit Fund, the state's General Fund, or the state's Employment Training Tax. The state can also create a new tax or establish authority to sell bonds to make interest payments.

If a state fails to pay interest to the federal government by the required date, employers in the state could lose the entire 5.4 percent federal offset credit on their FUTA taxes and the state could lose all grants for the costs of UI administration until the interest is paid.

Options for Restoring Solvency

- *Establishing Counter-Cyclical Financing*

California has a pay-as-you-go financing structure, which requires a tax increase during periods of economic downturn. By redesigning the tax-rate schedules to increase contributions in strong economic times and avoid higher taxes during periods of high unemployment, California employers would instead pay increased taxes during periods of economic growth.

California employers made low levels of investment in the UI system during the economic growth of the late '90s, resulting in a

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4 Cash-flow loans, obtained and repaid from January through September, are interest-free, however.

5 If a state has an outstanding loan balance on January 1 for two consecutive years and the full amount of the loan is not repaid before November 10 of the second year, state employers would automatically receive a reduction in the federal offset credit of 5.4 percent – which would result in an increase in their net FUTA payments of 0.8 percent.

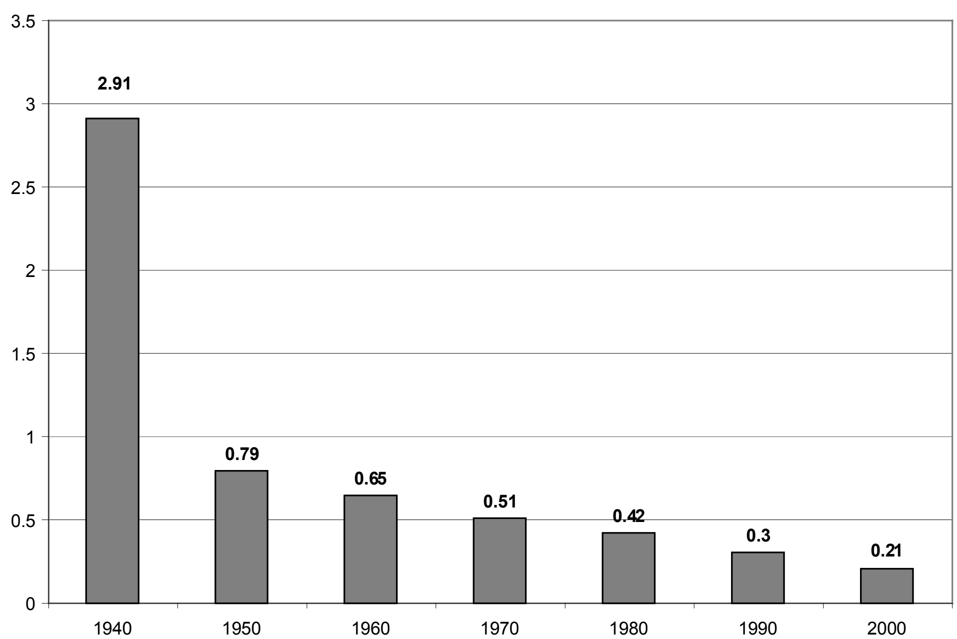
system that is not well-equipped to withstand economic downturns. A counter-cyclical financing system would enable the UI fund to sustain itself and provide relief to employers during economic slowdowns.

- *Adjusting the Taxable Wage Base*

UI payroll taxes are imposed on a taxable wage base, rather than on total wages paid to each employee. California is one of 10 states that has a $7,000 taxable wage base, the minimum allowed under federal law. Nearby states of Nevada, Oregon and Washington all have significantly higher wage bases of $21,500, $26,000 and $29,700 respectively. Arizona also has a taxable wage base of $7,000. (A state-by-state comparison of taxable wage bases is provided in Appendix #4.)

As the following chart indicates, California's taxable wage base has failed to keep pace with the growth in wages:

Ratio of California Taxable Wages to Total Wages



Source: U.S. Department of Labor

Increasing the taxable wage base would generate additional revenue in the UI trust fund. A low taxable wage base disadvantages employers of low-wage, part-time, seasonal and temporary workers because they pay a disproportionately high percentage of their payroll in UI taxes. To the extent that UI costs are absorbed by employees in the form of lower wages, a low taxable wage base also can amount to a regressive tax on low-wage workers.

Indexing the taxable wage base to inflation or to the average weekly wage in California would ensure that the wage base would keep pace with the growth in workers' wages. A 1997 study that compared the financing of the UI system with the Social Security system found that in 1940, both systems had a taxable wage base of $3,000, which was equal to average annual earnings at that time.[6] Today, the Social Security system has a wage base of $87,000, compared with the $7,000 wage base of California's UI system.

- *Increasing the Maximum Tax Rate*

Maximum UI tax rates range from 5.4 percent to 10 percent across the United States. A low maximum tax rate has the effect of holding down UI costs for employers with high utilization rates for UI benefits and spreading these costs – or socializing them – over the rest of the employer population. The maximum tax rate in more than half of the states – including California – is 5.4 percent. While 10 states have the lowest taxable wage base allowable – at $7,000 – only six states[7] including California have both the lowest maximum tax rate and the lowest taxable wage ceiling. Revenue in a state's UI fund is directly related to the maximum tax rate and the taxable wage base. One option for increasing the fund would be to increase the maximum tax rate.

- *Increasing the Solvency Surcharge*

California, along with 24 other states, assesses a surtax on employers when the balance in the state's unemployment fund falls below a specified level. California's solvency surcharge is 1.15 percent of the employers' tax rate when the UI trust fund falls below 0.6 percent of taxable payroll. The threshold for assessment of a solvency surcharge or the amount of the surcharge could be increased to generate additional revenue for the fund.

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[6] O'Leary, Christopher and Wandner, Stephen, *Unemployment Insurance in the United States,* W.E. Upjohn Institute for Employment Research, Kalamazoo, MI: 1997. pp 330-332.

[7] California, Arizona, Florida, Mississippi, Nebraska and South Carolina.

- *Creating a Loan and Interest Repayment Surtax*

A number of states have provisions triggering additional taxes when the state has an outstanding federal UI loan. Some states also have authority to issue bonds to pay benefit costs as a way of avoiding federal loans. They assess special taxes to pay off the bonds and related costs. Since interest must be paid on federal loans and may not be paid from the state's unemployment fund, some states have established special taxes to pay the costs of interest. California could explore mechanisms such as these to address any potential insolvency in its UI fund.

Conclusion

UI trust fund revenues have not kept pace with the increase in the average weekly wage in California and changes in the labor market. Even without the recent increases in California's UI benefit levels, the system's financing structure has been inadequate to meet the state's needs during periods of economic downturn.

California faces the threat of UI fund insolvency and borrowing. Unless the state acts to generate additional revenue for the UI trust fund, it could be forced to borrow money from the federal government or some other source and employers would be required to bear the costs of this borrowing. Early resolution of this financing shortfall would minimize the costs to employers by avoiding the payment of interest on borrowing.

A variety of financing options could be utilized to generate the revenue required to maintain UI trust fund solvency. The two most important considerations in maintaining the stability of this fund for both employers and workers are to enhance the counter-cyclical funding of the system and to adjust the taxable wage base to reflect growth in state wages.

Counter-cyclical funding allows employers to invest greater amounts during periods of economic growth to ensure the UI trust fund is equipped to handle the economic downswings that inevitably follow periods of prosperity. While it is always difficult for employers to experience increased contribution rates, increases are easiest for employers to absorb when the business climate is strong and profits are higher.

Having a taxable wage base and benefit levels that reflect the growth in wages would help ensure a stable and viable UI program to buffer workers and communities from the effects of prolonged unemployment. Recent increases in benefit amounts have moved in this direction. As a companion measure, the state's taxable wage base could be adjusted to reflect growth in wages since the last increase in the taxable wage base over 20 years ago.

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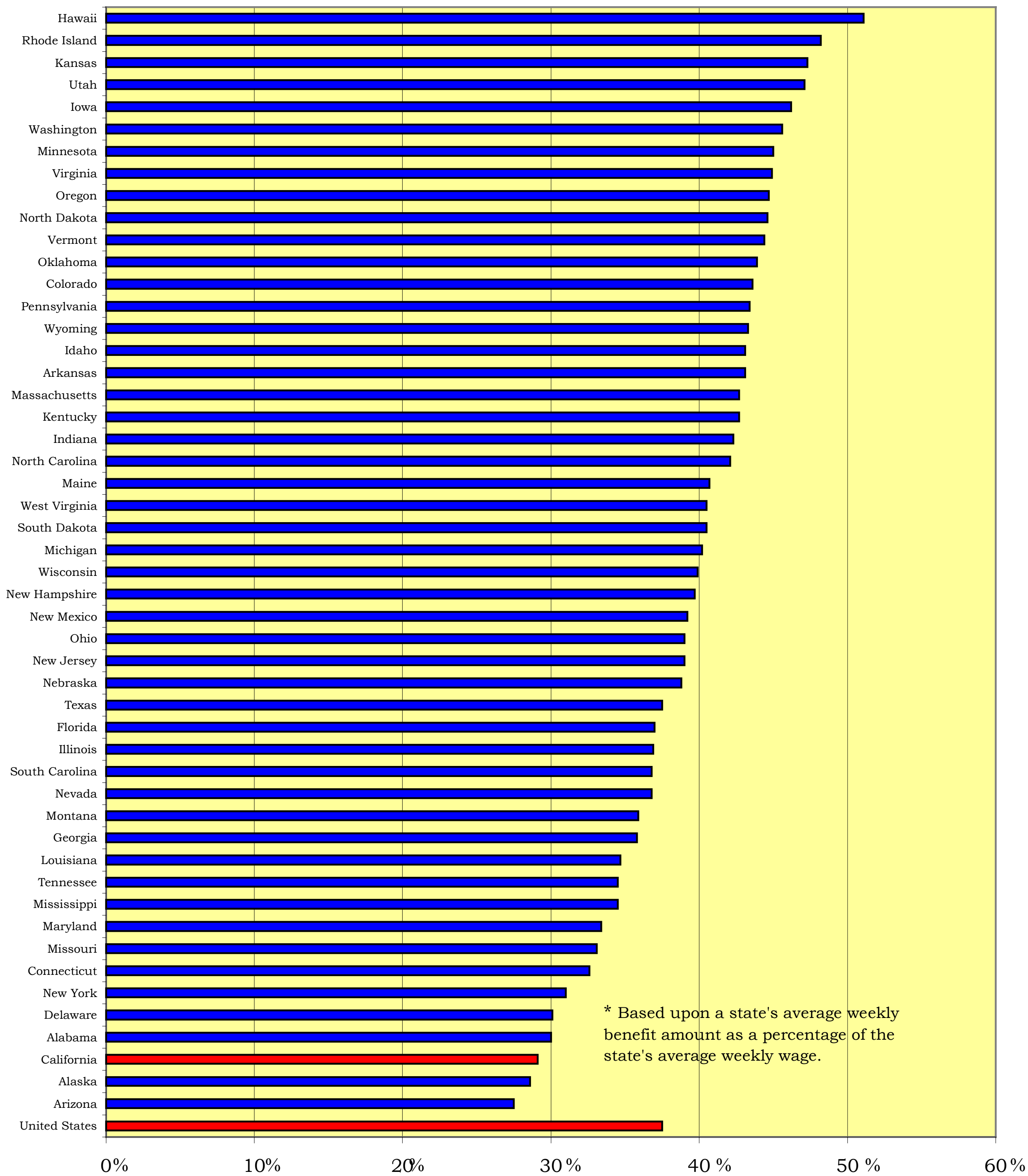
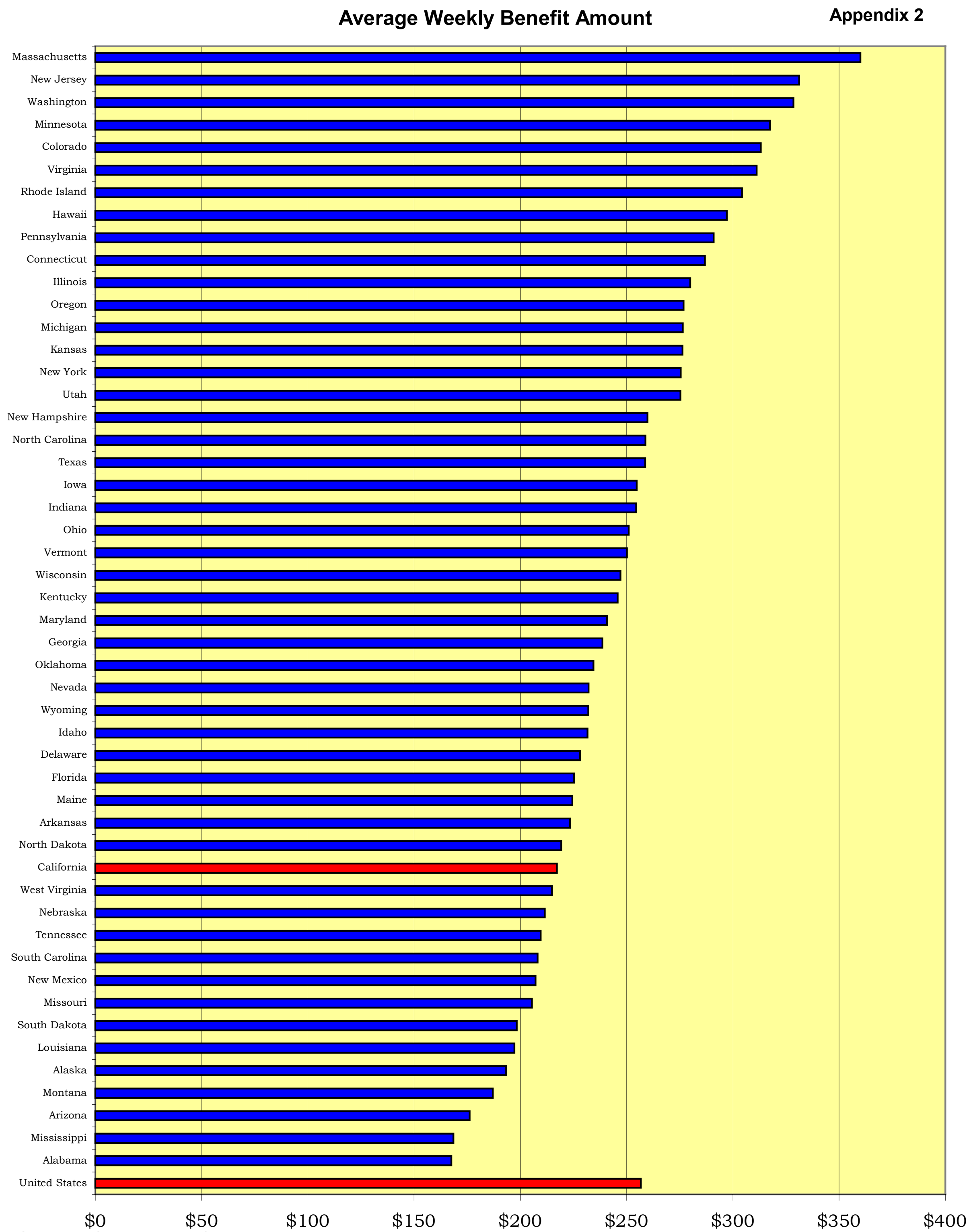
Appendix I

Percentage of Wages Replaced by Unemployment Insurance Benefits*



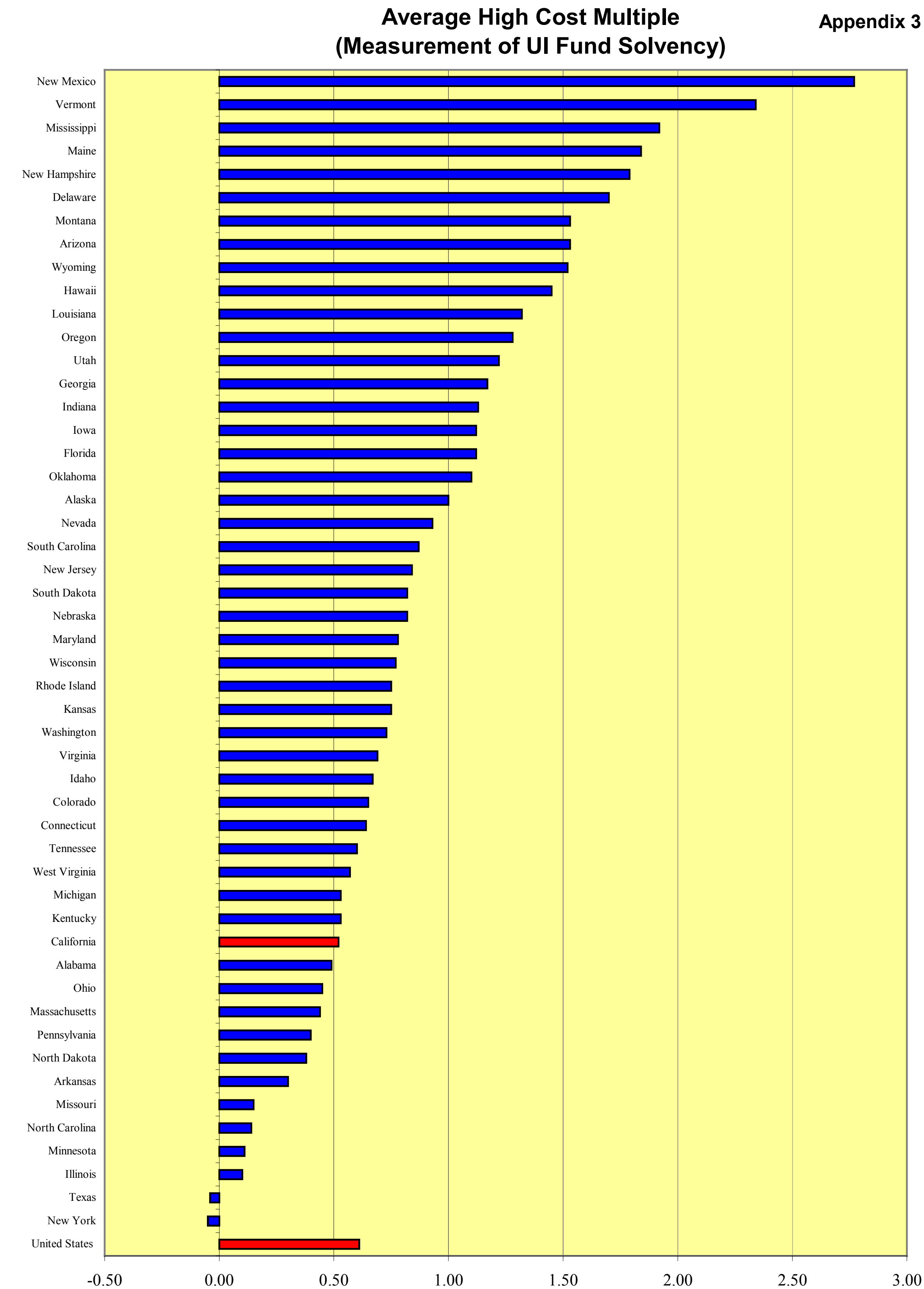
Source: U.S. Department of Labor,
UI Benefits Data, 2002, 4th Quarter

Appendix 2



Source: U.S. Department of Labor
UI Benefits Data, 2002

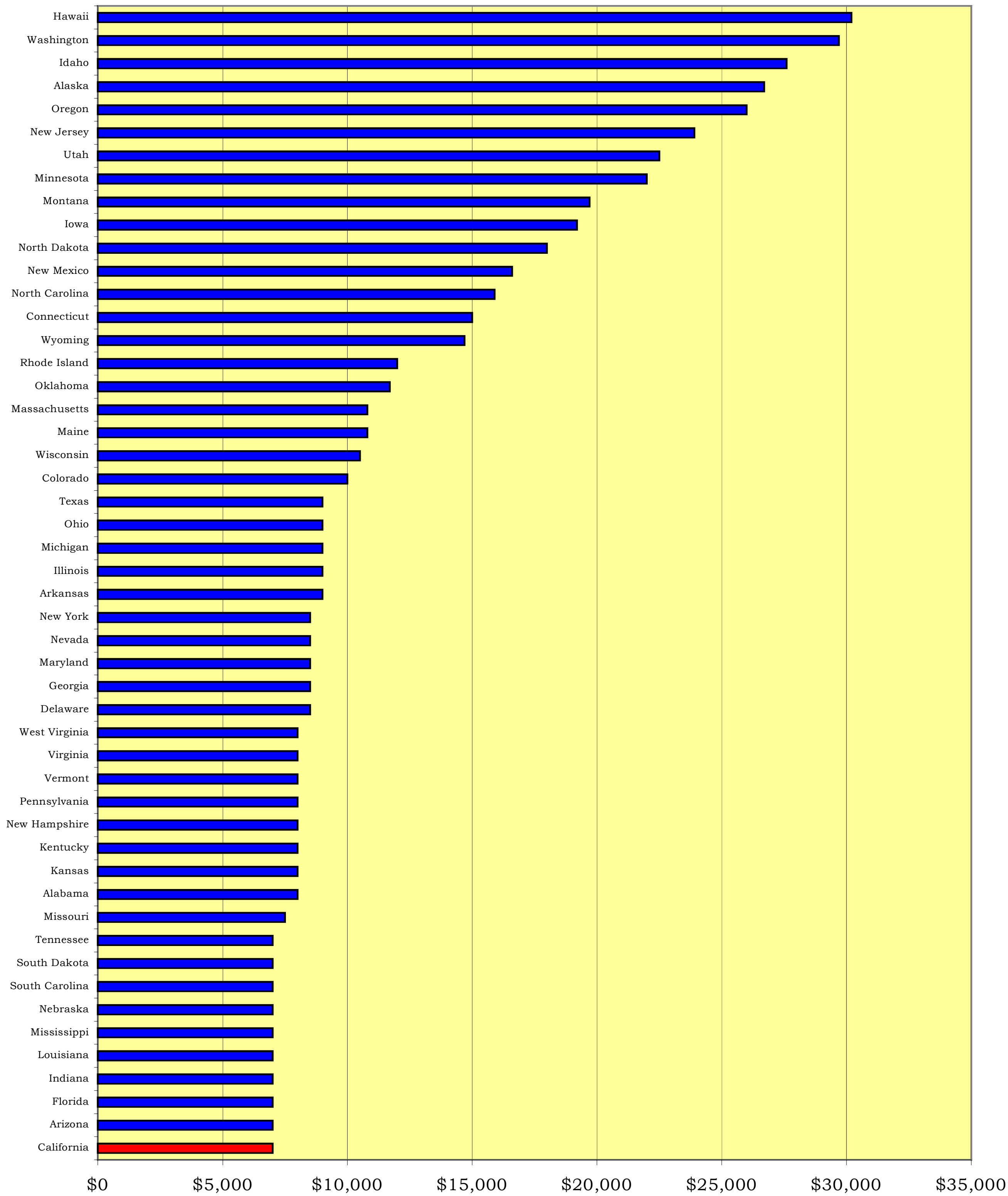
Appendix 3



U.S. Department of Labor
UI Financial & Labor Force Data, 2002, 4th Quarter

Appendix 4

State Taxable Wage Base 2003



Source: U.S. Department of Labor
UI Financial & Labor Force Data, 2002, 4th Quarter