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RUNNING OUT OF MONEY

California's Unemployment Insurance Fund Faces Insolvency

California's unemployment insurance fund has been operating with low reserves over the last five years. This didn't present a problem in the expanding economy of recent years. Yet now, as California and the nation experience an economic decline, or possibly a recession, the state's unemployment insurance (UI) fund balance is falling rapidly and soon will face insolvency.

The California Employment Development Department (EDD) issued its semiannual forecast on the status of the UI fund in May of this year. At the end of 2007 the fund's balance was $2.4 billion, and EDD projected the fund balance would fall to $1.1 billion at the end of 2008, resulting in a $256 million deficit by the end of 2009 (this forecast was based on a 6 percent unemployment rate for both 2008 and 2009).

Then in Governor Schwarzenegger's May revision to his proposed 2008–09 budget, the California Department of Finance projected a higher state unemployment rate of 6.4 percent for 2008 and 6.6 percent for 2009. Given these unemployment projections, the UI fund's year-end balance would fall to a $1.56 billion deficit in December 2009 and a $3.55 billion deficit in December 2010. Even these calculations provide an optimistic scenario, since, as of June 2008, state unemployment numbers have climbed to 6.9 percent.

Growing Unemployment Rates Shrink California's Reserves
Experts predict California's unemployment insurance fund will reach a $3.55 billion deficit by the end of 2010, which would be the largest deficit recorded in the state since the fund was established in 1935.

How the Unemployment Insurance Program Is Financed

The Social Security Act of 1935 created the unemployment insurance program as a federal–state partnership. Federal law provides the overarching program provisions and states design their own benefit levels and benefit-tax structure.

Employers pay a Federal Unemployment Tax Act (FUTA) payroll tax to cover the federal and state administrative costs of the unemployment insurance program and state employment service program. This tax also pays for the federal government's share of benefits under an extended unemployment insurance program and it funds loans to states that need to borrow from the federal government to meet their obligations to pay UI benefits. The FUTA tax is

6.2 percent on the first $7,000 in annual wages paid to an employee; this tax is then reduced by a 5.4 percent offset credit (a credit that applies to states that conform to federal requirements for operating the UI program), resulting in a net tax of 0.8 percent.

States establish their own benefit levels, eligibility requirements, and tax structure, and employers pay into the unemployment insurance fund. The amount an employer pays depends on the number of employees, the state's taxable wage base, the state's contribution rate schedule, and the employer's past use of the UI fund. The money is held in the state's UI trust fund account in the federal treasury.

California's unemployment insurance tax rate is 6.2 percent, the maximum allowable by state law (5.4 percent with an additional 15 percent surcharge). It has been at this level since 2004. The state's taxable wage base also is set by state law at $7,000 per employee (the average national taxable wage base is $13,749); California is one of eight states with the lowest taxable wage base in the nation.

What Happens When a State Is Unable to Pay Unemployment Insurance Benefits?

When a state trust fund is depleted and UI benefits cannot be paid, a state must either borrow money from a federal loan fund or seek other methods of financing, such as borrowing from other state-level funds or issuing bonds. State employers are subject to penalties if a federal loan is not repaid within a specified period of time: If a state has an outstanding federal loan balance on January 1st for two consecutive years, the state must repay the entire loan by November 10th of the second year; if the loan is not repaid, the federal offset credit of 5.4 percent

Financial Implications Loom
If California were unable to pay unemployment benefits due to a depleted unemployment insurance fund, the state would have to borrow money from the federal government or find other financing solutions, such as issuing state bonds.

that employers receive would be reduced by at least 0.3 percent every year until the loan is repaid.

Interest is charged on federal government loans to states, except for cash-flow loans obtained and repaid January through September of the same calendar year. However, if a state still has a federal loan balance at the end of the calendar year, the state is liable for paying interest on any loan made during the calendar year. If the interest is not paid by the due date, employers lose their 5.4 percent offset credit and state administrative grants are suspended until the interest is paid. Furthermore, a state's UI fund cannot be used either directly or indirectly to pay off interest costs.

California's Mounting Debt

The most current—and optimistic—unemployment insurance fund scenario indicates that California will begin borrowing federal funds in early 2009 and paying an estimated $85.8 million in interest costs in September 2010, and the state will end 2010 with a $3.55 billion fund deficit. The longer California's—or any state's—UI program runs at a deficit, the more drastic the interventions will need to be.

Written by Rona L. Sherriff. The California Senate Office of Research is a nonpartisan office charged with serving the research needs of the California State Senate and assisting Senate members and committees with the development of effective public policy. It was established by the Senate Rules Committee in 1969. For more information and copies of this report, please visit **www.sen.ca.gov/sor** or call **(916) 651-1500**.

Sources: California Employment Development Department; Federal Funds Information for States, Issue Brief 08-31; U.S. Department of Labor, Office of Workforce Security.