CALIFORNIA BUDGET PROJECT

budget brief

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REBUILDING THE FOUNDATION FOR CALIFORNIA'S UNEMPLOYMENT INSURANCE SYSTEM

California's Unemployment Insurance (UI) system faces a significant financial crisis: Demands on California's Unemployment Insurance Trust Fund have exceeded available resources since 2009 and the state has been forced to borrow from the federal government to pay amounts owed to jobless workers. This crisis has two distinct parts. The immediate problem – an interest payment on the federal loan is due soon, and employers will pay higher taxes starting in November 2011 to repay the loans – could be addressed by federal waivers of interest and principal on UI loans. The second and more fundamental problem – the fact that benefits owed exceed revenues paid into the Trust Fund – can be addressed by modernizing the financing structure for California's UI program. Increasing the share of wages subject to the UI tax would raise the revenues necessary to prevent erosion in the purchasing power of unemployed workers' benefits, keep dollars flowing through local economies during economic downturns, and build a stronger foundation for California's UI program going forward.

California Must Pay Interest on Federal UI Loans by September 2011

California's UI trust fund ran out of funds on January 26, 2009, and the state is borrowing from the federal UI trust fund to pay benefits owed to jobless workers. The state's UI trust fund deficit was $10.4 billion on March 16, 2011 – more than the total of all benefits paid in 2010 – and is projected to reach $16.0 billion at the end of 2012.[1]

Loans from the federal UI trust fund that are obtained in January through September and repaid by the end of September of the same year are interest-free. Any outstanding balance as of October 1, however, must be repaid with interest. The American Recovery and Reinvestment Act of 2009 (ARRA) – a $787 billion package of spending and tax measures designed to boost the economy – waived interest on federal UI loans through December 31, 2010, but interest began accruing on January 1, 2011.

Interest on federal UI loans cannot be paid from employers' contributions to the UI trust fund; it must come from the state's General Fund or another revenue source, such as special assessments on employers.[2] Under current law, California must pay $362.3 million in interest by September 30, 2011, and additional interest payments will be due each September for the foreseeable future. Governor Brown's 2011-12 Proposed Budget borrows from the state's Unemployment Compensation Disability Fund – commonly known as the State Disability Insurance fund – to make the interest payment that is due in September 2011.

Federal UI Taxes Will Increase if Loans Are Not Repaid by November 2011

States with outstanding loans from the federal UI trust fund on January 1 of two consecutive years must repay the entire loan by November 10 of the second year. If a state fails to repay its loan on time, federal UI tax rates are increased until the loan is repaid – generally, by 0.3 percentage points each year for two or more years, and then more steeply (Table 1).[3]

How California's UI System Is Financed

California's UI system is funded by state and federal taxes paid by employers. The federal tax pays for program administration, a portion of long-term benefits during recessions, and other federal costs. The federal tax rate is 6.2 percent, but employers in states that comply with federal UI regulations – including California – receive a 5.4 percent credit against this tax, so their effective tax rate is 0.8 percent.[4] (The state tax, which primarily funds regular UI benefits, is a variable, "experience-rated" tax, which means that tax rates reflect the UI system's costs that are attributable to a particular employer.) California has seven tax rate schedules, plus a 15 percent solvency surcharge schedule. The highest rate schedule, which includes the surcharge, is in effect in California at least through 2012.

Employers pay UI taxes on each employee's annual wages up to a "taxable wage base." California's taxable wage base has been set at the federal minimum of $7,000 since 1983, when the federal base was last increased. The $7,000 wage base equaled 36.8 percent of California's average annual wage in 1983, but just 13.6 percent of the average annual wage in 2009 (Figure 1).

UI systems tend to be either "forward-funded" or "pay-as-you-go." In a forward-funded system, a state's UI trust fund accumulates significant financial reserves during periods of low unemployment. These reserves fund benefit payments during periods of high unemployment, minimizing the need for higher tax rates during economic downturns. In contrast, a "pay-as-you-go" system collects employer contributions that are roughly equal to benefit payments on an annual basis. Such a structure does not build sufficient reserves to last through periods of increasing demand, and UI tax rates tend to increase during recessions in response to the rise in benefit payments. California's UI system has been gradually transformed from a "forward-funded" to a "pay-as-you-go" system over the past 25 years.

Table 1: Employers Will Pay Higher Federal Taxes Until the UI Fund Becomes Solvent

Year	Maximum Annual Federal UI Tax Per Employee
2011	$56
2012	$77
2013	$98
2014	$119
2015	$140
2016	$196

Source: Legislative Analyst's Office

California had an outstanding federal loan on January 1, 2010 and January 1, 2011; thus, the state's federal loan balance is due by November 10, 2011. If the balance is not paid by then, employers' federal UI tax will increase from a maximum of $56 for each employee in 2011 to a maximum of $77 in 2012. If the loan balance remains unpaid, the employer tax could eventually increase to $434 per employee per year.

Federal Action Could Provide Short-Term Help

Congress has a number of options for helping states address their immediate UI crises. For example, the federal government could:

- Continue to waive interest payments on federal UI loans beyond the two-year waiver period provided under the ARRA;
- Delay employer tax increases scheduled to be imposed in states that do not repay federal UI loan balances on time; and
- Forgive part of loan balances for states that improve the solvency of their UI system.

A bill pending in the US Senate offers this assistance. The bill would waive interest and principal payments for two years and allow the Secretary of Labor to forgive part of outstanding loan balances for states that take steps to strengthen their UI system financing while maintaining current UI eligibility standards and benefit levels.[5]

Raising the Taxable Wage Base Would Improve Long-Term Solvency

The solvency of California's UI system requires an adequate financing system. The amount of employers' contributions to the UI trust fund depends largely on two factors: The tax rate structure and the taxable wage base. As noted above, employers are currently paying taxes under the state's highest rate structure. California has not increased the taxable wage base since 1983 – that is, in nearly 30 years. In inflation-adjusted terms, California's current taxable wage base of $7,000 is less than half its 1983 level. Only two other states have a $7,000 taxable wage base: Arizona and Florida.[6]

California employers' UI contributions are lower as a share of total wages than they were for most of the post-World War II era due to the failure to increase the taxable wage base as wages rise. California collects taxes on too small a portion of wages paid in the state to develop an adequate trust fund balance – even during

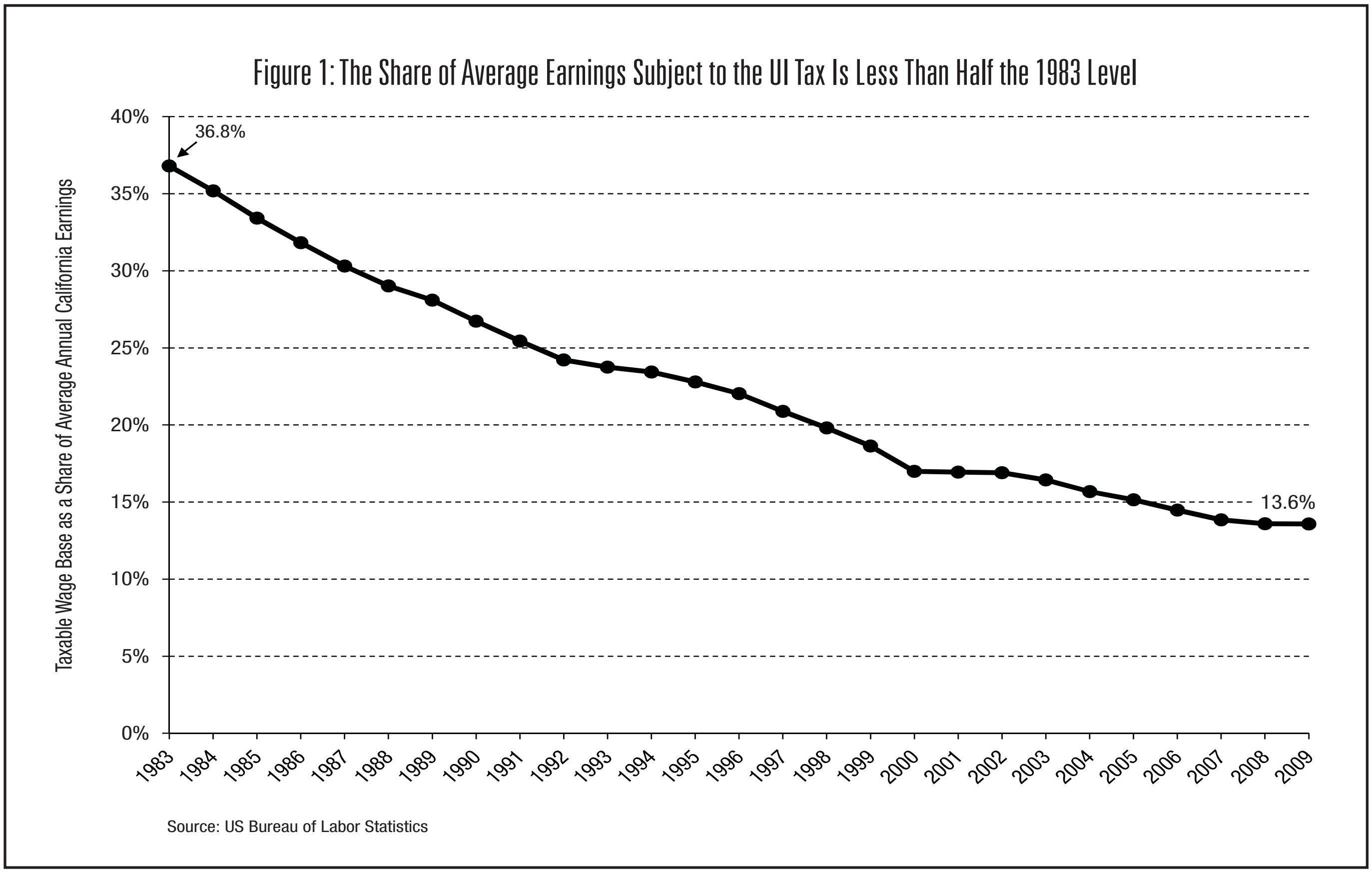
Figure 1: The Share of Average Earnings Subject to the UI Tax Is Less Than Half the 1983 Level
Taxable Wage Base as a Share of Average Annual California Earnings
36.8%
13.6%
40%
35%
30%
25%
20%
15%
10%
5%
0%
1983
1984
1985
1986
1987
1988
1989
1990
1991
1992
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Source: US Bureau of Labor Statistics

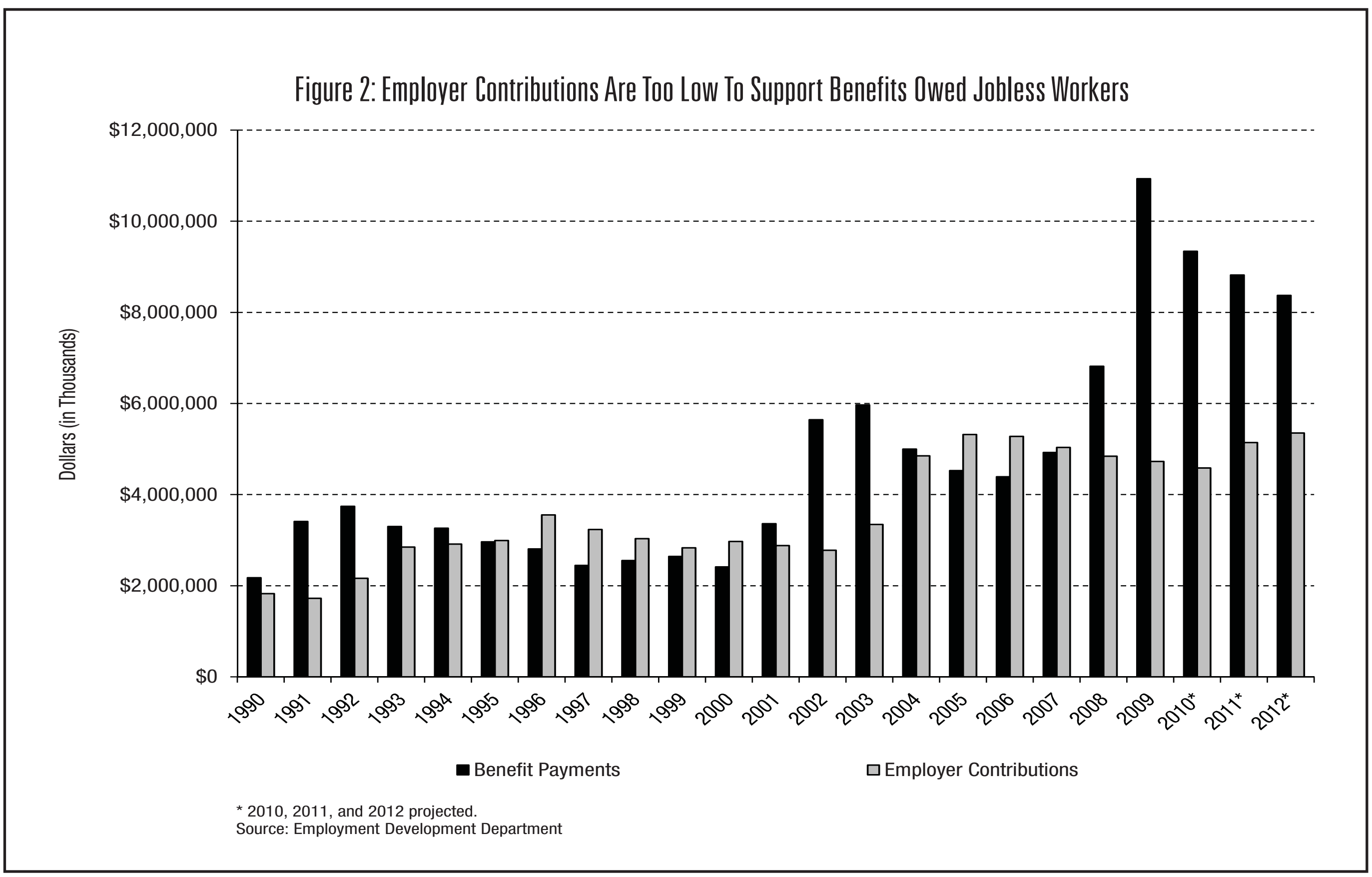
Figure 2: Employer Contributions Are Too Low To Support Benefits Owed Jobless Workers
Dollars (in Thousands)
$12,000,000
$10,000,000
$8,000,000
$6,000,000
$4,000,000
$2,000,000
$0
1990
1991
1992
1993
1994
1995
1996
1997
1998
1999
2000
2001
2002
2003
2004
2005
2006
2007
2008
2009
2010*
2011*
2012*
Benefit Payments
Employer Contributions
* 2010, 2011, and 2012 projected.
Source: Employment Development Department

periods when benefits payments are relatively low (Figure 2). Indexing the taxable wage base – that is, adjusting it annually to reflect changes in average weekly wages – will help ensure that the UI system has the resources it needs to meet the demands of a changing economy, even during economic downturns: States that have indexed bases were less likely to have to borrow from the federal government to pay UI benefits during the Great Recession than states that did not have indexed bases.[7]

California's Legislature and the federal government both have authority to increase the amount of wages subject to the UI tax. Seventeen states increased their taxable wage base in 2011, including Mississippi, which doubled its base from $7,000 in 2010 to $14,000 in 2011. President Obama's proposed budget for federal fiscal year 2012 and a bill pending in the US Senate include measures to increase and index the federal taxable wage base. States' taxable wage bases must be at least as high as the federal base, so an increase in the federal base would raise California's taxable wage base, bringing in additional state UI tax revenues that would help address California's long-term solvency problem.

Experts propose a number of changes that could bring California's UI system into solvency by 2020. Those reforms include:

- Gradually raising the federal taxable wage base;
- Indexing the federal taxable wage base so it rises with wage growth; and
- Providing federal incentives for states to "forward-fund" their UI systems, building reserves when unemployment is low.[8]

Conclusion

Fixing California's UI financing system over the long term and making it "forward-funded" requires a commitment to solvency and a willingness to bring employer contributions into balance with benefit payments. The debate over potential changes should consider the UI system's fundamental goals of providing an adequate level of temporary wage replacement to workers who become jobless through no fault of their own and stabilizing the economy during economic downturns by boosting the purchasing power of unemployed workers.

Vicky Lovell prepared this Budget Brief *with assistance from Jean Ross. The California Budget Project (CBP) was founded in 1994 to provide Californians with a source of timely, objective, and accessible expertise on state fiscal and economic policy issues. The CBP engages in independent fiscal and policy analysis and public education with the goal of improving public policies affecting the economic and social well-being of low- and middle-income Californians. General operating support for the CBP is provided by foundation grants, subscriptions, and individual contributions. Please visit the CBP's website at www.cbp.org.*

ENDNOTES

1 The Employment Development Department forecasts that regular UI benefit payments will total $9.3 billion in 2010. Employment Development Department, *October 2010 Unemployment Insurance (UI) Fund Forecast* (no date), p. 1. In addition, federally funded extended benefit payments to California workers totaled approximately $1.5 billion in 2010. US Department of Labor, *Unemployment Insurance Data Summary, 4th Quarter 2010* (no date), p. 17, downloaded from http://workforcesecurity.doleta.gov/unemploy/content/data_stats/datasum10/DataSum_2010_4.pdf on March 28, 2011.

2 The California Chamber of Commerce has suggested that interest on federal UI loans could be paid from Employment Training Panel funds. California Chamber of Commerce, *Projected $27.3 Billion UI Fund Deficit by 2012 Could Lead to Higher Taxes on Employers* (January 2010), p. 71.

3 Specifically, the federal UI tax rate remains the same, but the credit that employers receive against that tax rate is reduced by 0.3 percentage points for each of the first two years after the loan becomes due. For instance, the 5.4 percent credit that employers typically receive against the 6.2 percent federal tax rate would be reduced to a 5.1 percent credit in the first year that automatic principal payments are due. The reduction in the credit in the third and subsequent years includes the 0.3 percent per year change and additional "add-on" credit reductions if state UI tax collections meet certain criteria. California is expected to be subject to add-on credit reductions starting in the fifth year after the loan payment is due – that is, in 2016.

4 The federal UI tax rate includes a 0.2 percent surtax enacted in 1976. The surtax has been extended repeatedly since then but is scheduled to expire in June 2011. President Obama's proposed budget for federal fiscal year 2012 makes the surtax permanent.

5 The Senate bill would allow loan-reduction agreements to last for up to seven years.

6 The highest base is $37,300, in Washington.

7 Seventeen states have indexed bases. National Employment Law Project, *Unemployment Insurance Financing in Crisis: How Should States Respond to Trust Fund Insolvency?* (May 2010), p. 9.

8 One proposal would raise the federal taxable wage base to $16,000 while reducing federal UI tax rates so that employers' federal UI contributions would not increase. Michael Leachman, et al., *Rebuilding the Unemployment Insurance System: A Deficit-Neutral Plan That Limits Tax Increases and Maintains Benefits* (Center on Budget and Policy Priorities and the National Employment Law Project: February 9, 2011), p. 2.