Building a Sound Foundation for California's Unemployment Insurance System

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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. Support for the CBP comes from foundation grants, publications, and individual contributions. Grants from the Rockefeller and Rosenberg Foundations supported the preparation of this report. This report was prepared by Jean Ross and Matthew Mitchell.

California Budget Project
921 11th Street, Suite 502
Sacramento, CA 95814
(916)444-0500
(916)444-0172 (fax)
cbp@cbp.org
www.cbp.org

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EXECUTIVE SUMMARY

California's unemployment insurance (UI) trust fund faces a projected deficit of $722 million at the end of 2004. This deficit is the result of a growing imbalance between employer contributions into the UI trust fund and the benefits paid to workers out of the fund. In order to maintain benefit payments to unemployed workers, the state has applied for a loan from the US Department of Labor, which it expects to draw down beginning in April 2004. While other states have turned to the federal government for help under similar circumstances, this loan would mark the first time that California has had to borrow in order to make required benefit payments to UI claimants.

Building a Sound Foundation for California's Unemployment Insurance System analyzes the roots of this crisis. This report finds that the current financing crisis predates the state's 2001 UI benefit increase, which moved California from a low to a moderate benefit state. The crisis stems from the fact that the current system is structurally incapable of generating sufficient revenues to pay the benefits owed to unemployed workers. The taxable wage base – the maximum amount of a worker's wages on which an employer must pay taxes – has remained fixed at $7,000, the minimum allowed by federal law since 1983. The failure of taxable wages – wages subject to UI taxes – to grow in line with total wages has created a structural imbalance between the revenues coming into the UI system and the benefits owed to unemployed workers. Even at the state's maximum UI tax rate, the amount of wages subject to taxation are insufficient to meet the UI trust fund's obligations, much less to build a sufficient reserve to meet demands on the fund during economic downturns.

The report also finds that the structure of California's UI system disadvantages some businesses, industries, and some workers. Industries that are seasonal or project-based are major beneficiaries of the UI system; in contrast, low-wage workers and employers of low-wage workers receive fewer benefits from the UI system. To address these problems, this report recommends that policymakers:

- Implement a temporary surcharge to address the current deficit and restore the UI trust fund to solvency.

- Raise California's taxable wage base to the $12,768 average of the 50 states and, in the future, index the taxable wage to the state's average annual wage.

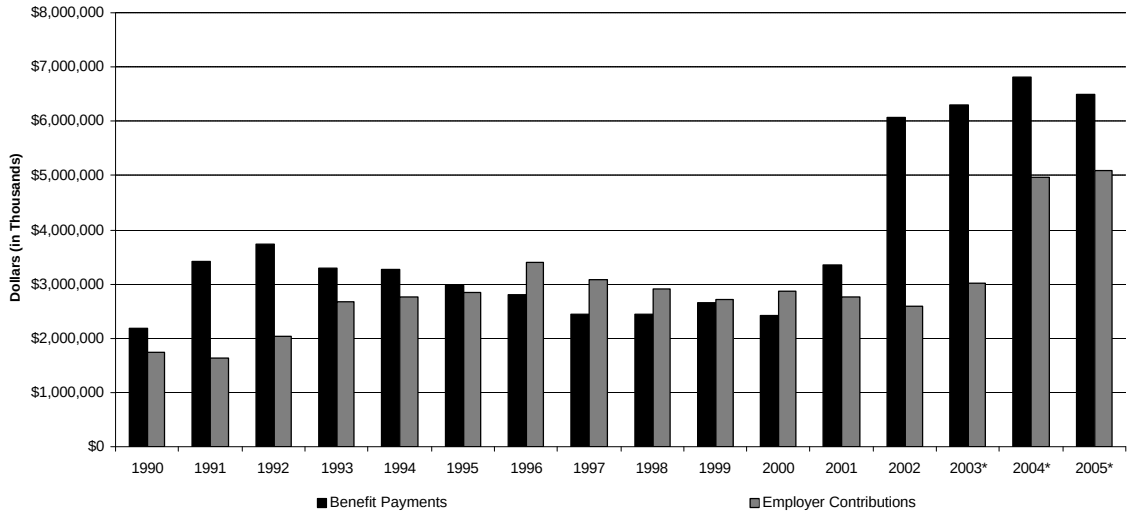
- Adopt a system-wide solvency goal based on the recommendations of the federal Advisory Council on Unemployment Compensation and use this goal as the basis for restructuring the state's UI financing system.

- Adopt an "alternate base period" that would count recent earnings toward determining eligibility for UI benefits.

INTRODUCTION: DIMENSIONS OF THE CURRENT CRISIS

California's unemployment insurance (UI) system faces a significant financial crisis. For many of the past 13 years, there has been a serious gap between employer contributions to the UI system and benefits paid to unemployed workers (Figure 1). Even in good years, employer contributions have barely equaled benefit payments. The situation worsened in 2001 and, by early 2004, California was on the verge of borrowing from the federal government in order to pay for legally required benefits.

Figure 1: Benefits Paid and Employer Contributions to California's Unemployment Insurance Trust Fund, 1990-2005



*2003, 2004, and 2005 forecasted.
Source: Employment Development Department

The California Employment Development Department (EDD) estimates that the gap between employer contributions to the unemployment system and payments to unemployed workers will be $1.9 billion in 2004 and $1.4 billion in 2005.[1] While borrowing will enable the state to fulfill its legal obligations, this loan must be repaid, and borrowing will not restore the system to long-term solvency.

Building a Sound Foundation for California's Unemployment Insurance System examines the current fiscal crisis in California's UI system. The report provides a brief overview of the UI system, what it is and how it works, identifies and analyzes the key issues in the UI financing structure, and offers a set of viable policy options for restructuring UI financing.

What Happens When a State's UI Trust Fund Is Insolvent?

Federal law requires states to pay UI benefits to eligible jobless workers.[2] If the state does not have sufficient resources to pay legally obligated benefits, it can borrow from the federal government or, as some states have done, seek financing in the private market. Four states – Illinois, Minnesota, Missouri, and New York – had outstanding federal loan balances at the end of 2003.[3] California expects to borrow from the federal government in April 2004 in order to fulfill its obligations.

States can obtain two types of loans from the federal government. Loans that are obtained and repaid within a single federal fiscal year are interest-free. Any outstanding balance as of October 1, however, must be repaid with interest. The state can repay the principal of a loan out of the UI trust fund. However, any interest owed cannot be repaid from the regular UI taxes paid by employers, but must come from the state's General Fund or other existing or new tax revenues, such as a dedicated tax levy.[4]

If the state is unable to repay a loan during a specified period, employers lose a portion of their federal unemployment tax offset credit. The additional levy on employers increases in each year that the state has an outstanding loan balance. In the second year after the state takes out an initial loan, employers are subject to a 0.3 percent additional UI tax levy. The levy increases to 0.6 percent in the third year after an initial loan and then increases steeply if the state maintains an outstanding balance.[11] Thus, employers pay a stiff penalty if the system is not restored to solvency within a relatively short period.

Why Does California Face an Unemployment Crisis Now?

The number of unemployed workers and unemployment insurance benefit claimants remains high: After reaching a low of 794,000 in January 2001, the number of unemployed workers in California peaked at 1,197,100 in July 2003 and stood at 1,082,500 in February 2004.[5] The number of initial UI benefit claimants in California peaked at 825,178 in the first quarter of 2002, up substantially from a low of 540,532 in the third quarter of 2000. In the fourth quarter of 2003, the number of initial benefit claims remained high at 728,545.[6]

Workers are staying unemployed for longer: In the fourth quarter of 2003, the average duration of unemployment in California was 18.1 weeks, up 3.1 weeks from the recent low of 15.0 weeks in the second quarter of 2001.[7] California's unemployment benefit duration last reached 18 weeks in 1993, following the severe recession of the early 1990s.[8]

More workers are exhausting their unemployment benefits than at any time in recent history: In the fourth quarter of 2003, nearly half the California workers receiving UI benefits (49.1 percent) exhausted those benefits before finding another job. This number was above the US benefit exhaustion rate of 43.5 percent. The 50.1 percent UI benefit exhaustion rate posted in the second quarter of 2003 was the highest recorded in California since 1940.[9]

Nationally, long-term unemployment is disproportionately affecting older and more educated workers: Recent research found that the total number of people without work for six months or more nearly doubled between 2000 and 2003, rising by 198.2 percent. Long-term unemployment is up even more for workers with a bachelor's degree or higher (299.4 percent); workers aged 45 and older (217.6 percent); management, business, and financial workers (308.5 percent); and professional workers (339.2 percent).[10]

BACKGROUND: WHAT IS THE UI SYSTEM AND HOW DOES IT WORK?

The nation's unemployment insurance system, created as part of the 1935 Social Security Act, is a federal-state partnership. The two central goals of the UI system are to ensure the financial security of workers who lose their jobs through no fault of their own and to provide an "automatic" stimulus to consumer demand during recessions. The system also provides an incentive to firms to minimize layoffs, and to help reduce the dispersal of skilled workers when employers must temporarily reduce staffing levels. Federal law requires that virtually

all wage and salary employees are included in the UI system.[12] Fewer than half of the nation's unemployed – 41 percent in the 4th quarter of 2003 – receive unemployment benefits due to the UI system's requirement that workers must have lost their job through no fault of their own, along with monetary and other eligibility criteria.[13]

UI System Financing

State and federal taxes levied on employers fund the UI system. A 0.8 percent federal tax on the first $7,000 of each covered employee's wages pays for program administration, a portion of extended benefits, and other federal costs. The state tax, which primarily funds regular UI benefits, is a variable, "experience rated" tax. Under experience rating, tax rates vary based on the UI system's costs attributable to a particular employer. Just as automobile drivers who cause the most accidents pay the highest insurance premiums, firms that "cause" more unemployment through layoffs pay higher taxes.

The Taxable Wage Base

One important characteristic of a UI system is the size of its taxable wage base (TWB). The TWB is the maximum amount of a worker's wages on which an employer must pay taxes. In the second quarter of 2003, California was one of ten states with a TWB of $7,000, the minimum allowed under federal law.[14] In contrast, 24 states had a TWB between $7,001 and $12,000; seven states had a TWB between $12,001 and $20,000; and nine states – including Oregon, Washington, and Nevada – had a TWB of $20,001 or higher. As a percentage of average annual wages, California's TWB is the lowest among the 50 states (Table 1).

Experience Rating and UI Tax Schedules

In addition to the taxable wage base, two factors determine the amount of UI taxes paid by an employer: the employer's experience rating history and the tax rate schedule in effect in a given year. California has seven tax rate schedules (AA through F), combined with a 15 percent solvency surcharge schedule (F+). The EDD determines which schedule to use for each calendar year, based on a formula that divides the balance in the trust fund on September 30 of the prior calendar year by total covered wages paid for the prior completed state fiscal year. If the resulting figure is less than 0.6 percent, the highest F+ surcharge schedule takes effect.

Under experience rating, the tax rate paid by an individual

Characteristics of the Unemployment Insurance System

A federal-state partnership: States administer the basic UI program; states pay for regular benefits provided to workers; and states are free within broad constraints to make decisions about taxation, benefits, and eligibility. The federal government pays for the administrative costs of running the program; the federal treasury holds the UI trust fund for each state. During times of high unemployment, the federal government traditionally provides extended unemployment compensation.

Not part of the regular state budget: The unemployment insurance trust fund is separate from the state's regular operating budget. When California maintains a positive balance in the fund, the federal treasury pays interest on this balance. The federal government loans money to states that fail to maintain a positive balance and charges interest on these loans if they are not repaid within a specified period.

Table 1: California's Taxable Wage Base Is Lowest as a Percentage of Average Pay						
State	Employer Contributions as a Percentage of Taxable Wages (2nd Quarter 2003)	Employer Contributions as a Percentage of Total Wages (2nd Quarter 2003)	Taxable Wage Base (2nd Quarter 2003)	Average Annual Pay (2002)	Taxable Wage Base as a Percentage of Average Annual Pay (2nd Quarter 2003)	Taxable Wage Base as a Percentage of Average Annual Pay Rank (2nd Quarter 2003)
Idaho	1.2	0.8	$27,600	$28,163	98.0%	1
Hawaii	1.5	1.1	$30,200	$32,671	92.4%	2
Washington	2.3	1.4	$29,700	$38,242	77.7%	3
Oregon	2.1	1.3	$26,000	$33,684	77.2%	4
Montana	1.1	0.8	$19,700	$26,001	75.8%	5
Utah	0.6	0.4	$22,500	$30,585	73.6%	6
Alaska	2.4	1.5	$26,700	$37,134	71.9%	7
North Dakota	1.5	0.8	$18,000	$26,550	67.8%	8
Iowa	1.4	0.8	$19,200	$29,668	64.7%	9
Nevada	1.3	0.8	$21,500	$33,993	63.2%	10
Minnesota	1.2	0.6	$22,000	$37,458	58.7%	11
New Mexico	1.0	0.5	$16,600	$29,431	56.4%	12
Wyoming	0.8	0.4	$15,900	$28,975	54.9%	13
New Jersey	1.6	0.8	$23,900	$45,182	52.9%	14
North Carolina	1.5	0.7	$15,900	$32,689	48.6%	15
Oklahoma	1.1	0.5	$11,700	$28,654	40.8%	16
Maine	1.6	0.7	$12,000	$29,736	40.4%	17
Rhode Island	3.0	1.1	$12,000	$34,810	34.5%	18
Arkansas	2.3	0.8	$9,500	$28,074	33.8%	19
Wisconsin	2.2	0.7	$10,500	$32,464	32.3%	20
Connecticut	2.8	0.9	$15,000	$46,852	32.0%	21
West Virginia	2.8	0.9	$8,000	$28,612	28.0%	22
South Dakota	0.7	0.2	$7,000	$26,360	26.6%	23
Colorado	1.0	0.3	$10,000	$38,005	26.3%	24
Ohio	1.7	0.5	$9,000	$34,214	26.3%	25
Mississippi	1.7	0.5	$7,000	$26,665	26.3%	26
Kansas	1.7	0.6	$8,000	$30,825	26.0%	27
Kentucky	2.3	0.7	$8,000	$30,904	25.9%	28
Vermont	2.0	0.6	$8,000	$31,041	25.8%	29
Alabama	1.7	0.5	$8,000	$31,163	25.7%	30
Texas	2.1	0.6	$9,000	$36,248	24.8%	31
Massachusetts	2.5	0.7	$10,800	$44,954	24.0%	32
Georgia	0.6	0.2	$8,500	$35,734	23.8%	33
Nebraska	1.6	0.4	$7,000	$29,448	23.8%	34
Michigan	3.2	0.8	$9,000	$38,135	23.6%	35
South Carolina	1.9	0.5	$7,000	$30,003	23.3%	36
Louisiana	1.7	0.4	$7,000	$30,115	23.2%	37
Illinois	2.8	0.7	$9,000	$39,688	22.7%	38
Missouri	1.8	0.5	$7,500	$33,118	22.6%	39
Pennsylvania	3.9	1.0	$8,000	$35,808	22.3%	40
New Hampshire	0.9	0.2	$8,000	$36,176	22.1%	41
Florida	1.3	0.3	$7,000	$32,426	21.6%	42
Maryland	1.4	0.4	$8,500	$39,382	21.6%	43
Tennessee	2.4	0.6	$7,000	$32,531	21.5%	44
Virginia	0.9	0.2	$8,000	$37,222	21.5%	45
Indiana	1.8	0.4	$7,000	$32,603	21.5%	46
Delaware	1.7	0.4	$8,500	$39,684	21.4%	47
Arizona	0.8	0.2	$7,000	$34,036	20.6%	48
New York	4.1	0.8	$8,500	$46,328	18.3%	49
California	**2.9**	**0.6**	**$7,000**	**$41,419**	**16.9%**	**50**
50 State Average	**1.8**	**0.6**	**$12,768**	**$33,877**	**38.5%**	

Sources: US Department of Labor, Employment and Training Administration and US Bureau of Labor Statistics, Covered Employment and Wages Program

employer depends on that employer's history or experience. The tax rate varies among employers even though only one rate schedule is in effect during a given calendar year. Employers with more and more frequent layoffs pay more, while those that never or very infrequently cause layoffs pay at a lower rate. For example, an employer with a history of few layoffs (Employer A) might be on Line 30, whereas an employer with a history of frequent layoffs (Employer B) might be on Line 5 (Table 2). If schedule E were in effect, Employer A's UI tax rate would be 2.4 percent, whereas Employer B's would be 5.4 percent.

Table 2: Tax Schedule and Experience Rating Grid

	Tax Schedules							
	AA	A	B	C	D	E	F	F+
Experience Rating Line 1	5.4	5.4	5.4	5.4	5.4	5.4	5.4	6.2
Experience Rating Line 5	4.9	5.0	5.3	5.4	5.4	5.4	5.4	6.2
Experience Rating Line 10	4.4	4.5	4.8	5.1	5.3	5.4	5.4	6.2
Experience Rating Line 15	3.9	4.0	4.3	4.6	4.9	5.2	5.4	6.2
Experience Rating Line 20	3.0	3.2	3.5	3.8	4.1	4.4	4.7	5.4
Experience Rating Line 25	2.0	2.2	2.5	2.8	3.1	3.4	3.7	4.3
Experience Rating Line 30	1.0	1.2	1.5	1.8	2.1	2.4	2.7	3.1
Experience Rating Line 35	0.4	0.6	0.8	1.0	1.2	1.4	1.7	2.0

Source: Employment Development Department

Ineffectively Charged Benefits, Non-Charged Benefits, and Inactive Charges

One purpose of experience rating in a UI system is to discourage employers from laying off workers, by increasing the UI tax paid by employers that engage in frequent layoffs. However, the unemployment insurance system is not fully experience-rated. If a business incurs UI costs that exceed the contributions generated by the maximum tax rate, the system spreads the excess costs among the state's remaining employers.

These costs are called ineffectively charged benefits. In 2002, 27.9 percent of benefits paid were ineffectively charged, up from 17.8 percent in 1999.[15] California tends to have a higher than average rate of ineffectively charged benefits. This higher rate reflects, in part, the importance of seasonal and project-based industries, such as agriculture and film production, to the state's economy. These industries engage in more frequent and, often, large layoffs. To the extent to which the firms in these industries do not bear the full costs of the benefits paid to their workers, they place an additional burden on the UI system and, therefore, on employers overall.

Other costs that are not subject to experience rating include non-charged benefits, which are UI benefit payments that are not attributed to a particular employer, and inactive charges, which are benefits charged to employers who are no longer active in the UI system, and thus are not taxed. In 2002, 6.4 percent of benefit payments were non-charged, while 12.4 percent of benefit payments were attributable to non-active accounts. An example of a non-charged benefit is a payment to worker who leaves a job to accompany a spouse to a new location. These payments are not charged to the worker's employer since that firm was not responsible for the employee's loss of work. Inactive charges typically reflect firms that have gone out of business and thus no longer pay wages that are subject to the UI tax.

Nearly half (46.7 percent) of 2002 benefit payments were not subject to experience rating, up from 35.9 percent in 1999. As noted above, most of the increase was attributable to ineffectively charged benefits. Non-charged benefits and inactive charges remained a relatively constant share of benefit payments between 1999 and 2000.[16] The high degree of ineffectively charged and non-charged benefits, and benefits attributable to inactive account, weakens the ability of the state's UI financing system to act as a disincentive to frequent layoffs. This is due to the fact that many employers are at the maximum tax rate and thus do not face an increased tax burden when they terminate employees, while other employers pay higher rates due to the actions of others.

Eligibility Determination and Benefit Levels

The financing structure of a state's UI system determines the level of funding the system takes in; the state's eligibility requirements and legally established benefit levels affect how much the state pays out in benefits in response to a given level of unemployment.

Historically, California's benefit levels have been extremely low; however, the state's workers have had somewhat easier access to UI benefits than workers have in other states. In the second quarter of 2001, prior to the state's recent benefit increase, California's average weekly UI benefit payment was $169.32, higher than only Alabama and Mississippi and far below the US average of $234.73.[17] SB 40 of 2001 raised the state's maximum UI benefit and changed the formula for determining benefit levels.[18] SB 40 increase the maximum weekly benefits from $230 to $330 on January 1, 2002, to $370 on January 1, 2003, and to $410 on January 1, 2004. The maximum benefit will increase to $450 for claims filed on or after January 1, 2005.

California's UI benefits remain moderate in comparison to those of other states, despite the recent increases. California ranked 28th among the states with respect to average weekly UI benefits paid during the fourth quarter of 2003, averaging $250.69 as compared to the US average of $261.44.[19] Additional increases in maximum benefits are expected to raise the average weekly benefit amount in California to $263.47 in 2004.[20] In mid-2003, California's average weekly UI benefit replaced only 31.4 percent of the average weekly wage of UI recipients. On this wage replacement measure, California ranked 45th among the 50 states.

In contrast, California ranks modestly higher with respect to the share of jobless workers who receive UI benefits. In 2003, 15 states had a higher UI recipiency rate than did California.[21] The recipiency rate reflects the number of insured individuals unemployed in the regular UI program as a percentage of the total unemployed workforce. During 2003, 46 percent of California's unemployed received UI benefits, as compared to 41 percent for the nation as a whole.[22]

While access to UI benefits is higher than in some other states, California's eligibility requirements disadvantage low-wage workers relative to their higher-waged counterparts. The primary reason is the state's definition of the base period. A base period is a yearlong span of work history used to determine whether a UI applicant has sufficient earnings to qualify for benefits. California law establishes eligibility for UI benefits using an individual's earnings during the first four of the past five completed calendar quarters.

This definition of a base period ignores amounts earned during the current and most recently completed quarters. A person with substantial recent work history may be denied UI benefits – or experience a delay in receiving benefits – due to insufficient work history within the base period. For example, the eligibility of a person trying to establish a claim in June 2004 is based on the amount earned between January 1 and December 31, 2003. Evidence suggests that low-wage workers, who tend to have more intermittent work histories, are the most disadvantaged by failing to count a worker's most recent earnings toward eligibility.[23]

Key Issues in the Financing Structure of California's UI System

The impending insolvency of California's UI trust fund presents policymakers with two key issues. The first is the extent to which the system is "counter-cyclical," that is, whether the UI trust fund builds reserves in good economic times that can be drawn down during periods of high unemployment. The second critical issue is whether the current financing system is capable of generating the resources needed to pay benefits owed to jobless workers. A third concern is the fact that some industries and employers do not shoulder the full burden of their layoffs; this is less central to the current financial crisis, but policymakers should consider this fact as they design solutions to restore the system to solvency.

What Is a Reasonable Solvency Goal?

There are three common measures of UI trust fund solvency: the reserve ratio, the high cost multiple (HCM), and the average high cost multiple (AHCM).

Reserve Ratio: The reserve ratio is a state's trust fund balance as a percent of total wages for the past 12 months. In effect, this measure compares the size of the trust fund balance against the size of the risk it insures.

High Cost Multiple (HCM): The HCM provides a measure of the trust fund's ability to pay recession-level benefits out of its reserves. A HCM of 1.0 means that a state has sufficient reserves to pay 12 months of benefits at the fund's highest level of payments without relying on additional payroll tax revenues. Experts note that the HCM, which looks at the highest cost period in a state's history, may not accurately reflect future demands on a state's trust fund, particularly if the state's labor force or UI system has significantly changed.[27]

Average Cost Multiple (AHCM): The AHCM is similar to the HCM, except that the AHCM is based upon the average of benefit payments during the three most recent high cost calendar years that include either three recessions or at least 20 years of payment history. Experts note that the AHCM reflects conditions that are more typical than the highest year used for the HCM and thus may constitute a more reasonable benchmark for assessing the ongoing solvency of a state's UI trust fund.

Pay-as-You-Go Versus Forward Funding

The fundamental problem confronting California's UI system is that the UI trust fund does not have sufficient funds to provide benefits to all eligible workers, particularly during economic downturns. There are three commonly used measures of UI trust fund solvency: the reserve ratio, the high cost multiple (HCM), and the average high cost multiple (AHCM). California's UI trust fund is in trouble by all three of these measures. In 1995, the federal Advisory Council on Unemployment Insurance Compensation – a "blue ribbon" panel charged with recommending options for strengthening the nation's UI system – recommended that states aim for an AHCM of 1.0 as an overall solvency target.[24] In the fourth quarter of 2000, California's AHCM was 0.76, below the recommended level, and ranking

37th among the 50 states.[25] By the fourth quarter of 2003, California's AHCM had fallen to 0.13, ranking 43rd among the 50 states.[26]

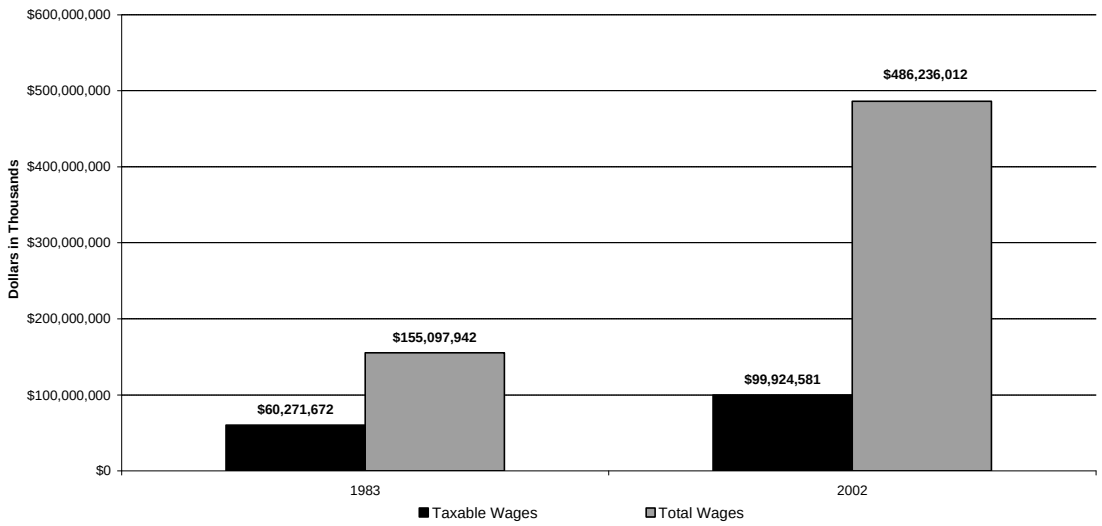
One reason for the trust fund's impending insolvency is that the state's UI system has been gradually transformed from a forward funded to a pay-as-you-go system over the past two decades. A forward funded system accumulates significant financial reserves during periods of low unemployment. These reserves support benefit payments during periods of high unemployment, minimizing the need for higher tax rates. As a result, forward funded systems are considered "counter-cyclical."

In contrast, a pay-as-you-go system is one in which employers' contributions into the trust fund roughly equal payments out of the trust fund on an annual basis. Such a structure does not build a sufficient reserve to tide the trust fund through periods of increasing demand. In a pay-as-you-go system, UI tax rates tend to increase during recessions in response to the rise in benefit payments.

The UI Trust Fund's Revenues Haven't Kept Pace with Benefits

The structure of the state's UI financing system impedes the trust fund's ability to build a sufficient reserve and has made the state's UI system less counter-cyclical and more pay-as-you-go over time. California's low TWB is primarily responsible for the shift; the state's taxable wage base has not changed since 1983. In 1983, wages subject to unemployment

Figure 2: Taxable Wages Fail to Keep Pace With Total Wages Paid to Workers Covered by UI



Source: US Department of Labor, Employment and Training Administration

insurance taxes (taxable wages) were $60.3 billion, while total wages for workers on payrolls covered by unemployment insurance were $155.1 billion (Figure 2). By 2002, total wages had grown by 213.5 percent, to $486.2 billion, while taxable wages rose by just 65.7 percent, to $99.9 billion.

In 1983, taxes paid into the UI trust fund equaled $1.6 billion, while benefits paid out of the trust fund totalled $2.2 billion. By 2002, payments into the trust fund had increased to $2.6

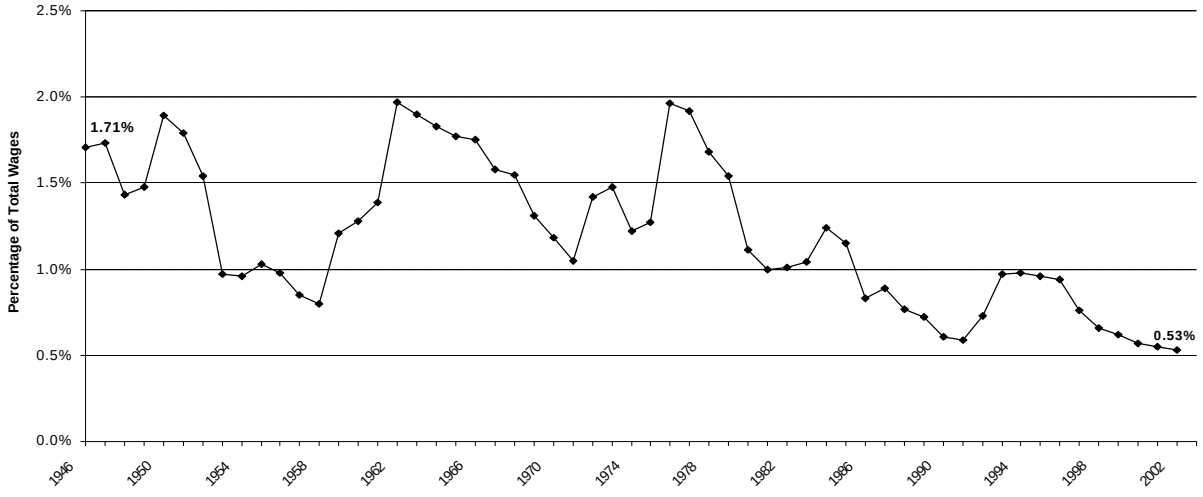
billion, (65.4 percent), while benefits had increased to $5.6 billion (161.7 percent).[28] By keeping the TWB constant, increases in trust fund revenues were driven almost entirely by a rise in the number of covered employees. Benefit payments, on the other hand, rose due to an increase in the number of persons drawing benefits as the labor force expanded, wage increases (thereby boosting benefit payments owed to jobless workers), and benefit increases enacted in 1989 and 2001.

The failure of the TWB to rise along with the growth in total wages created a structural imbalance between the revenues coming into the UI trust fund and its potential liabilities - an imbalance that grows over time. This imbalance has made forward funding virtually impossible, since the trust fund cannot accumulate sufficient revenues to support increased demands during periods of high unemployment.

Employers' Contributions to the UI System Have Declined as a Share of Total Wages

California employers' contributions to the UI system have declined as a share of total wages due to the failure to increase taxable wages in line with total wage growth. As a result, the share of total wages paid in UI taxes has declined markedly since the early 1960s (Figure 3). In 1967, during Governor Reagan's first year in office, UI taxes stood at 1.58 percent of total wages. In 1999, during Governor Davis' first year in office, UI taxes had fallen to 0.62 percent of total wages. By 2002, the last year for which a full year's worth of data is available, the UI taxes paid by California employers were only 0.53 percent of total wages, just one third of the 1967 level (Figure 3).

Figure 3: 2002 Unemployment Insurance Contributions as a Share of Total Wages Were Lowest Since 1946



Source: US Department of Labor, Employment and Training Administration

A Low Taxable Wage Base Puts an Upward Pressure on Tax Schedules

A low TWB also places upward pressure on tax schedules, because tax schedules are linked to a ratio that reflects the financial health of the trust fund. With a low TWB, higher rates are

needed to bring in sufficient revenues to meet the demands on the trust fund for benefit payments. Since the implementation of the current tax rate schedule in 1985, the lowest AA tax schedule has taken effect during only two years (1990 and 1991).[29] High unemployment during the recession of the early 1990s pushed rates to the E schedule in 1993; rates have not dropped below the C schedule since 1992. California employers face the highest tax rate schedule (F+) for the first time in 2004.[30]

A Low Taxable Wage Base Makes the UI Tax System More Regressive

A low TWB not only reduces revenue into the UI trust fund, it also makes the UI tax regressive, that is, a tax that falls disproportionately on employers of low-wage workers. Employers pay the tax on the full amount earned by workers making $7,000 or less per year, but not on amounts earned in excess of $7,000 per year. As a result, employers of workers with higher earnings pay taxes on a fraction of their total wages, and employers of workers with low earnings pay a higher effective UI tax rate.

Take, for example, two workers at different firms both taxed at the rate of 3.4 percent. One, a part-time receptionist, makes $7,000 a year; the other, an accountant, earns $50,000 a year. The employer pays $238 in UI taxes on behalf of each employee, equivalent to a tax rate of 3.4 percent of the wages of the receptionist versus a rate of 0.5 percent of the wages of the accountant.

How Common Are Fraud and Abuse?

The evidence seems to suggest that fraud and abuse in the unemployment insurance system are serious issues, involving substantial sums of money. Nationally, the General Accounting Office (GAO) estimates that about $577.4 million (approximately 2 percent) of the approximately $30 billion in UI payments that occurred in 2001 were due to fraud and abuse.[31] The GAO study mentioned numerous categories of fraud including errors in reported or unreported income, a claimant becoming unemployed for reasons that do not match state eligibility requirements, and claimants not actively searching for work.

Employers also abuse the UI system. Because of the "experience-rated" structure of the UI system, employers have an incentive to make employee terminations appear as if they were not true layoffs. Businesses also sometimes attempt to reduce their unemployment insurance tax rates by moving their payrolls to newly established entities with no record of layoffs. Legislation designed specifically to prevent such "SUTA dumping" practices has been signed in four states (Arkansas, Maine, North Carolina, and Washington).[32]

Fraud and abuse clearly must be addressed, but they are not the primary cause of the financial problems faced by California's UI system. The Employment Development Department estimates that claimant fraud totaled $118.7 million between January and September of 2003.[33] Even if fraud and abuse were two or three times this estimate, as some assert, entirely eliminating the problem would have made only a dent in the estimated $3.3 billion gap between UI benefit disbursements and employer contributions in 2003.

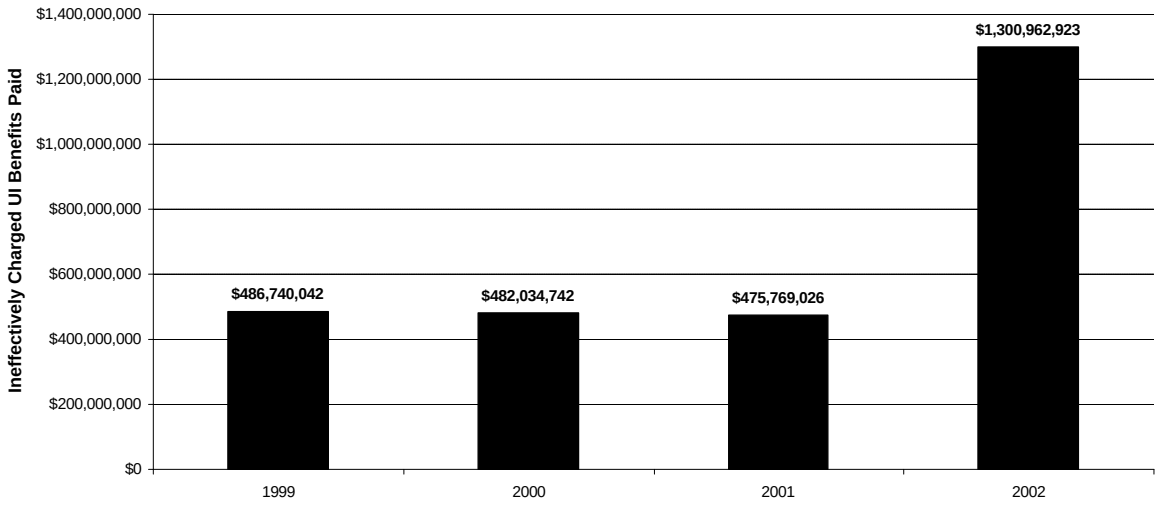
A Low Taxable Wage Base Increases the Percentage of Ineffective Charges

A low TWB makes it difficult to reward employers that rarely place demands on the trust fund with lower tax rates, thereby making experience rating less effective. Take, for example, an employer that lays off a third of its workforce. This employer only pays taxes on the first $7,000 of wages paid to its remaining workforce, no more than $378, per employee on the state's regular AA through F schedule, less than the amount need to pay two weeks

of benefits at the state's average weekly benefit amount. This employer is unlikely to make sufficient tax payments to meet the demands placed on the UI fund by its former employees. The benefit costs beyond this employer's contributions would be ineffective charges, borne by other employers. With a higher TWB, this employer's contributions would cover a larger share of the costs generated by its former employees, thereby lowering the burden on other employers.

In 2002, ineffectively charged benefits nearly tripled in California (Figure 4). After holding steady at just under $500 million between 1999 and 2001, the amount of ineffectively charged benefits rose to $1.3 billion in 2002. The more than doubling of ineffectively charged benefits between 2001 and 2002 significantly outpaced the 46.5 percent expansion in benefits effectively charged to individual employers.[34]

Figure 4: Ineffectively Charged Benefits More Than Doubled in 2002



Source: Employment Development Department

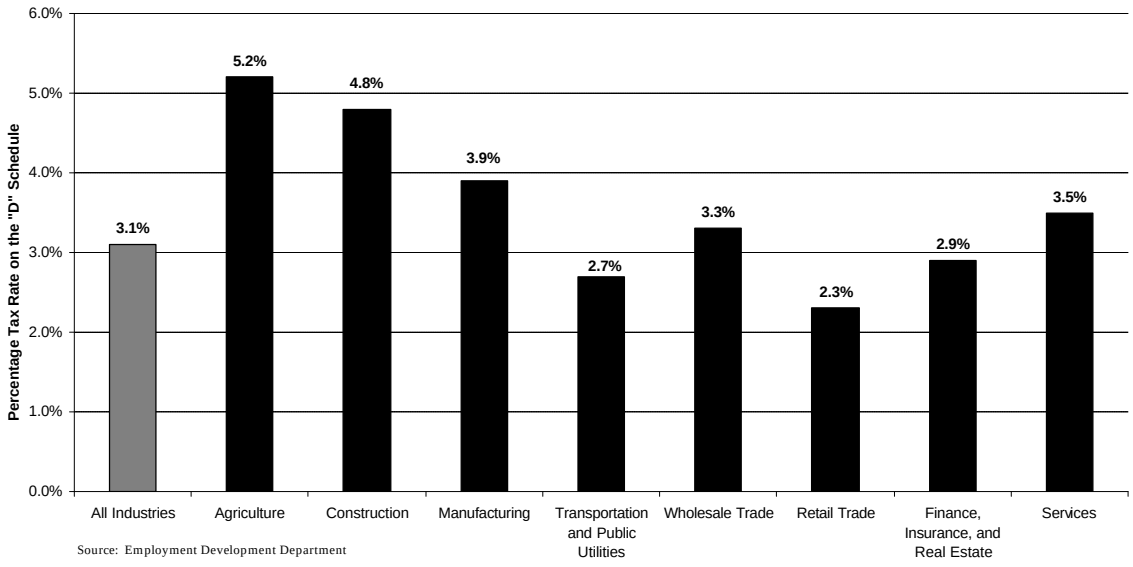
Some California Businesses and Industries Do Not Bear the Full Cost of Their Employment Decisions

Just as the rise in ineffectively charged benefits means that California employers that infrequently lay off workers effectively subsidize employers that more frequently cause unemployment, industries with relatively stable employment patterns subsidize the UI costs of more cyclical industries. This is true even though cyclical industries pay higher average unemployment insurance rates.

Agriculture and construction are examples of industries with a seasonal or project-based pattern of employment that regularly translates into large numbers of layoffs. Because of experience rating, firms in these sectors pay higher average unemployment insurance rates. In 2003, agricultural employers paid an average UI tax rate of 5.2 percent, while construction employers paid an average of 4.8 percent, as compared to a rate of 3.1 percent for California employers as a whole (Figure 5).

However, if these industries paid their "fair share" of UI taxes – that is, the share they would pay if the UI system were perfectly experience rated – their tax rates would be even higher. The state's 5.4 percent maximum tax rate prevents a higher level of experience rating.[35] Instead, stable industries, such as manufacturing and government, subsidize sectors that generate the most ineffective charges through frequent layoffs. In some cases, high unemployment sectors – such as construction, agriculture, and film production - effectively use the UI system to sustain their workforces during the regular periods of slack work. While there may be reasons for subsidizing certain industries through the UI system, policymakers should consider whether such a subsidy is desirable and how large it should be.

Figure 5: Average Unemployment Insurance Tax Rate by Industry (2003)



Source: Employment Development Department

RESTORING THE SOLVENCY OF CALIFORNIA'S UNEMPLOYMENT INSURANCE SYSTEM TRUST FUND

California must both address the immediate shortfall in the state's UI trust fund and the ongoing challenge of restoring the system to solvency. The crisis in the state's UI system is not the fault of unreasonably high benefits. As noted above, California ranks 28th among the 50 states with respect to average weekly benefit levels and 45th with respect to share of wages replaced by the average benefit payment.[36] Instead, the fundamental problem with the UI system is that the tax structure currently used to finance UI benefits is incapable of supporting the benefits to which California's jobless workers are legally entitled.

The current financing system limits employer contributions to $5.0 billion in 2004 and $5.1 billion in 2005. Since California employers will be paying taxes on the highest (F+) tax schedule, this represents the maximum revenue - generating potential of California's UI system. Even then, revenues are projected to fall significantly short of benefit payments (Table 3).

In the short term, funds borrowed from the federal government will make up the gap. However, if the state fails to address the underlying structural problems in the current system, employers will face additional federal tax levies and the state will be burdened with sizeable interest costs from ongoing borrowing. A number of changes are needed to correct this imbalance and ensure that California's UI trust fund has the resources it needs to fulfill its goals.

Table 3: Projected Operating Deficits of California's UI Trust Fund

	Employer Contributions	UI Benefits Paid	Contributions Minus Benefits	Unemployment Rate	Tax Schedule
2002	$2,586,741,150	$6,070,853,102	($3,484,111,952)	6.7%	C
2003	$3,006,279,000	$6,301,956,000	($3,295,677,000)	6.6%	D
2004	$4,955,867,000	$6,820,444,000	($1,864,577,000)	6.5%	F+
2005	$5,099,201,000	$6,492,140,000	($1,392,939,000)	6.3%	F+
2006	$5,259,531,000	$5,903,865,000	($644,334,000)	6.0%	F+
2007	$5,417,148,000	$5,945,727,000	($528,579,000)	5.9%	F+
2008	$5,574,851,000	$6,013,251,000	($438,400,000)	5.7%	F+

Source: Employment Development Department. 2003 and thereafter are projected.

1. Improve the Solvency of the UI System in the Long-Term

Reforms to California's UI financing system should:

- Generate sufficient revenue to meet the demands placed on the system during periods of high unemployment.

- Be fair to all workers and ensure that eligibility rules do not unduly burden low-wage workers.

- Ensure that funds are available to support an adequate standard of wage replacement for jobless workers.

In order to achieve these goals, policymakers should:

- ***Raise the taxable wage base to at least the national average.*** As a first step, California should raise its taxable wage base to the national average. Currently, the national average is $12,768, as compared to California's $7,000. Raising the taxable wage base will move California's UI trust fund toward forward funding and the ability to generate funds during good economic times to provide the trust fund with a reserve that is drawn down during periods of high unemployment. Over the long run, however, this will not be sufficient to ensure continued solvency.

- ***Index the taxable wage base to the state's average wage to ensure that the system remains in good fiscal health.*** Ensuring ongoing solvency requires additional steps. Over time, a capped taxable wage base will prevent the trust fund from meeting demands of rising wages and the need to maintain an adequate level of wage replacement. Indexing the state's taxable wage base – that is, adjusting it annually to reflect changes in average weekly wages – will ensure that the UI system has the resources it

needs to meet the demands of a changing economy.

Experts note that raising a state's taxable wage base tends to increase reserves, thereby boosting the UI system's ability to achieve its goal of economic stabilization.[37] An indexed taxable wage base will ensure that when benefit disbursements increase as total wages rise, the ability to finance those benefits increases as well. Thirteen states adjust their taxable wage bases in line with the growth in state average wages, and five other states have adopted some other form of "flexible" taxable wage base. According to the EDD, if California had raised its taxable wage base and then indexed it to 50 percent of the average annual wage beginning in 1994, the state's trust fund would be fully solvent and employers would be on the lowest possible tax schedule.[38]

- ***Adopt a system-wide solvency goal.*** California also should adopt a system-wide solvency goal to inform future UI policy debates.[39] If, for example, California were to adopt the target of an AHCM of 1.0 to 1.5, it would mean that the UI trust fund would have a reserve sufficient to cover 12 months to 18 months of benefit payments at any time, sufficient to meet the challenge of a serious economic downturn.

- ***Consider modifications to the state's tax rate schedule that move the system toward greater solvency.*** Currently, the tax schedule used to determine employers' tax rates is based on the balance in the UI trust fund as a percentage of wages covered by the system. A larger balance moves employers' tax rates to a low rate schedule and conversely, a smaller balance moves rates to a higher rate schedule. The solvency of the UI trust fund could also be improved by requiring a larger reserve in order to trigger a movement to a lower rate schedule. This would spread costs broadly among employers. Alternatively, a new, higher maximum tax rate could be added to the current rate schedule. This type of change would shift the burden of improving solvency to those employers who create the largest demands on the UI system through frequent and/or large layoffs.

2. Return the UI Trust Fund to a Positive Balance in the Short Term

In the short term, California must adopt some mechanism – such as a temporary surcharge on employers – to address the current solvency crisis, minimize the need for further borrowing, and pay interest costs on federal loans that cannot be paid out of the trust fund's regular revenues. The surcharge should be limited in duration. Policymakers will have to consider the trade-off between quickly restoring the trust fund balance, on the one hand, and minimizing the cost to employers, on the other. The more quickly the trust fund is replenished, the higher the surcharge – since the cost is spread over fewer years.

3. Create a More Equitable Approach to Eligibility Determination

While the urgent challenge is how to restore solvency to the UI trust fund, it is important that the solutions implemented also begin to move the UI system toward more equitable treatment of low-wage workers. The state should:

- ***Adopt an alternate base period.*** California's method for determining eligibility for UI benefits can deny or delay benefit payments to workers with significant recent earnings

and labor force attachment. This is because the formula now in use in California bases eligibility on earnings in the first four of the past five quarters, ignoring any earnings in the quarter under way and the most recently completed quarter. California should adopt a method of determining eligibility for benefits that takes into account wages earned in the most recent completed quarter.

Today, 18 states and the District of Columbia use alternate periods to calculate eligibility for workers who do not meet regular base period monetary requirements.[40] Three of these states (Hawaii, New Mexico, and Virginia) adopted an alternate base period during 2003.[41] An alternate base period considers earnings during the four most recently completed quarters. A 1995 study sponsored by the US Department of Labor found that adoption of an alternate base period disproportionately benefits low-wage, part-time, and intermittent workers.[42] In addition to making the UI system fairer, the Employment Development Department has estimated that two-thirds of new benefits associated with an alternate base period would be paid to individuals who otherwise would have qualified for cash assistance in the CalWORKs program.[43]

CONCLUSION

Fixing California's UI system requires a commitment to solvency and a willingness to address the structural imbalance between employer contributions and benefit payments. The solutions will impose a cost on employers, but will leave the overall cost of the UI system, measured as a percentage of total wages, below historic levels. 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 an economic downturn by boosting the purchasing power of unemployed workers.

An increase in the taxable wage base – the level of wages subject to the UI tax – is critical to restoring the system to solvency; continued solvency can only be ensured by linking the wage base to the growth in wages. Doing so will more equitably spread the burden of financing the UI system among employers and move the UI trust fund toward forward funding, thereby improving the system's ability to stabilize the economy. Finally, reforms to the state's UI system should make it more equitable in its treatment of low-wage workers by adopting an alternative method for determining eligibility for UI benefits that takes recent wages into account.

ENDNOTES

[1] Employment Development Department, *Unemployment Insurance (UI) Fund Forecast* (November 12, 2003). As of March 17, 2004, the trust fund faced a $722 million shortfall in 2004. The shortfall is less than the gap between contributions and benefit payments, since the state began the year with a positive balance in the fund and because of interest earnings on any positive balances.

[2] Rona Levine Sherriff, Senate Office of Research, *California's Unemployment Insurance Trust Fund Is at Risk of Insolvency* (August 2003), p. 4.

[3] US Department of Labor, Employment and Training Administration, *State Benefits Data – 4th Quarter 2003,* downloaded from http://www.workforcesecurity.doleta.gov/unemploy/content/data_stats/datasum03/4thqtr/benefits.asp on April 5, 2004.

[4] Rona Levine Sherriff, Senate Office of Research, *California's Unemployment Insurance Trust Fund Is at Risk of Insolvency* (August 2003), p. 4.

[5] Employment Development Department, *Civilian Labor Force, Employment, and Unemployment – Updated 3/10/2004* downloaded from http://www.calmis.ca.gov/file/lfhist/cal$shlf.txt on March 25, 2004.

[6] US Department of Labor, Employment and Training Administration, *UI Data Summary Tables, Regular Benefits Information by State* (1st Quarter 1999 through 4th Quarter 2003 inclusive), downloaded from http://www.ows.doleta.gov/unemploy/content/data.asp on April 7, 2004.

[7] US Department of Labor, Employment and Training Administration, *UI Data Summary Tables, Benefits and Duration Information by State* (1st Quarter 1999 through 4th Quarter 2003 inclusive), downloaded from http://www.ows.doleta.gov/unemploy/content/data.asp on April 7, 2004.

[8] US Department of Labor, Employment and Training Administration, *Annual Program and Financial Data ET Handbook No. 394* downloaded from http://www.ows.doleta.gov/unemploy/content/hdbk394_99/lnkca.html on April 6, 2004.

[9] US Department of Labor, Employment and Training Administration, *UI Data Summary Tables, Regular Benefits Information by State,* (1st Quarter 1999 through 4th Quarter 2003 inclusive), downloaded from http://www.ows.doleta.gov/unemploy/content/data.asp on April 7, 2004 and US Department of Labor, Employment and Training Administration, *Annual Program and Financial Data ET Handbook No. 394* downloaded from http://www.ows.doleta.gov/unemploy/content/hdbk394_99/lnkca.html on April 6, 2004.

[10] Sylvia Alegretto and Andy Stettner, *EPI Issue Brief Number 198: Educated, Experienced, and Out of Work: Long-Term Joblessness Continues to Plague the Unemployed* (Economic Policy Institute and National Employment Law Project: March, 2004), p. 6. This research analyzed all unemployed workers, not just those receiving unemployment insurance benefits.

[11] Ron Wilus, *The Dynamics of Trust Fund Solvency* (US Department of Labor: October 15, 2002).

[12] In California, excluded wage and salary employees include ministers and other individuals employed for religious purposes, certain household workers, elected officials, and family members employed by partnerships or sole proprietorships.

[13] US Department of Labor, Employment Training Administration, *UI Financial and Labor Force Data,* downloaded from http://www.ows.doleta.gov/unemploy/finance.asp on March 29, 2004. California's recipiency rate was 46 percent during 2003, ranking the state 16th among the 50 states.

[14] Suzanne Schwartz Simonetta and Loryn Lancaster, US Department of Labor, Employment and Training Administration, *Comparison of State Unemployment Insurance Laws 2003,* downloaded from http://www.ows.doleta.gov/unemploy/uilawcompar/2003/comparison2003.asp on April 6, 2004, pp. 2-4.

[15] Employment Development Department, S*ummary of ETA 204 Experience Rating Report 1999-2002* (August 2003).

[16] Employment Development Department, S*ummary of ETA 204 Experience Rating Report 1999-2002* (August 2003).

[17] US Department of Labor, Employment and Training Administration, *Benefits and Duration Information by State for CYQ: 2001.2,* downloaded from http://www.workforcesecurity.doleta.gov/unemploy/content/data_stats/datasum01/2ndqtr/sum.asp#ben on April 5, 2004. The US average includes the District of Columbia, Puerto Rico, and the Virgin Islands.

[18] Senate Bill 40 (Alarcon, Chapter 409 of 2001). SBX3 2 (Alarcon, Chapter 4 of 2002) made the January 1, 2002 benefit increase retroactive to claims filed on or after September 11, 2001 and before January 1, 2002. Increases apply to claims filed on or after the date noted.

[19] US Department of Labor, Employment and Training Administration, *Benefits and Duration Information by State for CYQ: 2003.4,* downloaded from http://www.workforcesecurity.doleta.gov/unemploy/content/data_stats/datasum03/4thqtr/sum.asp#ben on April 3, 2004. The US average includes the District of Columbia, Puerto Rico, and the Virgin Islands. California's rank is among the 50 states.

[20] Employment Development Department, *Unemployment Insurance Fund Forecast for Calendar Years 2003-2005* (October 2003).

[21] US Department of Labor, Employment and Training Administration, *UI Financial and Labor Force Data CYQ: 2003.4* downloaded from http://www.workforcesecurity.doleta.gov/unemploy/content/data_stats/datasum03/4thqtr/finance.asp on April 2, 2003.

[22] US Department of Labor, Employment and Training Administration, *UI Financial and Labor Force Data CYQ: 2003.4*, downloaded from http://www.workforcesecurity.doleta.gov/unemploy/content/data_stats/datasum03/4thqtr/finance.asp on April 2, 2003. The US average includes the District of Columbia, Puerto Rico, and the Virgin Islands. California's rank is among the 50 states. California's recipiency rates reflect, in part, policy choices, such as allowing victims of domestic violence to receive benefits if they leave a job to flee an abusive spouse. California is also one of the states that allow jobless part-time workers to receive UI benefits while they search for part-time work. US Department of Labor, Employment and Training Administration, *Nonmonetary Eligibility*, downloaded from http://www.ows.doleta.gov/unemploy/uilawcompar/2003/nonmonetary.pdf on April 3, 2004.

[23] US General Accounting Office, *Unemployment Insurance: Role as a Safety Net for Low Wage Workers in Limited* (December 2000), p. 15.

[24] Advisory Committee on Unemployment Compensation, *Collected Findings and Recommendations: 1994-1996* (Washington, DC: 1996), p. 11.

[25] US Department of Labor, Employment and Training Administration, *UI Data Summary Tables – 4th Quarter 2000, Summary Financial Information by State for CYQ 2000.4*, downloaded from http://www.ows.doleta.gov/unemploy/content/data_stats/datasum00/4thqtr/sum.asp#fin on March 30, 2004.

[26] US Department of Labor, Employment and Training Administration, *UI Data Summary Tables – 4th Quarter 2003, Summary Financial Information by State for CYQ 2003:4*, downloaded from http://www.ows.doleta.gov/unemploy/content/data_stats/datasum03/4thqtr/sum.asp#fin on March 30, 2004.

[27] Advisory Committee on Unemployment Compensation, *Unemployment Insurance in the US: Benefits, Financing, Coverage* (Washington, DC: 1996), p. 59.

[28] US Department of Labor, Employment and Training Administration, *Annual Program and Financial Data ET Handbook No. 394*, downloaded from http://www.ows.doleta.gov/unemploy/content/hdbk394_99/lnkca.html on March 30, 2004 and Employment Development Department (August 2003).

[29] Employment Development Department, *Unemployment Insurance Financing Experience* (August 2003).

[30] Employment Development Department, *Unemployment Insurance Fund Forecast* (October 2003).

[31] US General Accounting Office, *Unemployment Insurance: Increased Focus on Program Integrity Could Reduce Billions in Overpayments* (Washington, DC: July 2002), pp. 2 and 10.

[32] Rebecca Smith and Andrew Stettner, National Employment Law Project, *The Whole Truth: Employer Fraud and Error in the UI System*, downloaded from http://www.nelp.org/ui/federal/initiatives/wholetruth120203.cfm on March 31, 2004.

[33] Employment Development Department, *Unemployment Insurance Fraud and Non-Fraud Costs: January 2001 – September 2003* (November 2003).

[34] Employment Development Department, S*ummary of ETA 204 Experience Rating Report 1999-2002* (August 2003).

[35] On the F+ schedule, which imposes a 15 percent solvency surcharge, the maximum tax rate is 6.2 percent.

[36] US Department of Labor, Employment and Training Administration, *Benefits and Duration Information by State for CYQ: 2003.4* downloaded from http://www.ows.doleta.gov/unemploy/content/data_stats/datasum03/4thqtr/sum.asp#bendur on April 2, 2004. US Department of Labor, Employment and Training Administration, *UI Financial and Labor Force Data CYQ: 2003.4* downloaded from http://www.ows.doleta.gov/unemploy/content/data_stats/datasum03/4thqtr/finance.asp on March 29, 2004.

[37] Advisory Council on Unemployment Compensation, *Defining Federal and State Roles in Unemployment Insurance: A Report to the President* (Washington, DC, January 1996), p. 69.

[38] Employment Development Department, *Model of Current Trust Fund Balance if the Taxable Wage Base Was Indexed to 50% of the Average Annual Wage Effective 1994* (November 2003). Employment Development Department data provided to the Governor's Unemployment Insurance Task Force.

[39] California already uses the reserve ratio to determine which of the seven UI tax schedules will take effect for a given calendar year. Applying a solvency measure narrowly to this one element of the UI system has not, however, proved an adequate means to ensure that the state's UI program remains financially sound.

[40] Suzanne Schwartz Simonetta and Loryn Lancaster, US Department of Labor Office of Workforce Security, *Comparison of State Unemployment Insurance Laws 2003* downloaded from http://www.ows.doleta.gov/unemploy/uilawcompar/2003/comparison2003.asp. While California has two alternative methods to establish monetary eligibility, the state does not count earnings in the most recent completed quarter or the quarter in progress.

[41] Suzanne Schwartz Simonetta and Loryn Lancaster, US Department of Labor, Employment and Training Administration, *Comparison of State Unemployment Insurance Laws 2003*, downloaded from http://www.ows.doleta.gov/unemploy/uilawcompar/2003/comparison2003.asp on April 6, 2004, pp. 3-2 and 3-3. National Employment Law Project, *What is An "Alternative Base Period" and Why Does My State Need One?*, downloaded from http://www.nelp.org/ui/state/access/abpfactsheet041003.cfm on April 7, 2004. National Employment Law Project, *2003 State Legislative Highlights: Expanding Unemployment Insurance for Low-Wage, Women & Part-Time Workers* (August 8, 2003).

[42] Wayne Vroman, *The Alternative Base Period in Unemployment Insurance: Final Report* (US Department of Labor: 1995), p. 21.

[43] Senate Floor Analysis of AB 3010 (July 1, 2002).