

CALTAX COMMENTARY: RESTORING SOLVENCY TO A BROKEN UNEMPLOYMENT INSURANCE FINANCING STRUCTURE

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California operates one of the most expensive unemployment insurance (UI) systems in the nation. However, the employer-paid taxes needed to fund the system are not enough to support it.

The first step toward restoring solvency to the UI trust fund and establishing a healthy reserve is to take steps to improve California's business climate, to put people back to work. And when addressing the UI fund's solvency directly, California policy makers must take a prudent approach to avoid unnecessary tax increases during California's fragile economic recovery, and to prepare for the next recession. The reserve needs to be high enough to handle the financial pressure of another recession, but not so high that it takes an unnecessary amount of capital out of the economy.

Who bears the financial responsibility to fix the broken system? In some states, employers and employees alike share the burden of maintaining the mutually beneficial system that helps workers when they lose their jobs. In California, however, employees are not partners in the funding of UI, and the burden has been placed entirely on the backs of employers.

A comprehensive solution to California's UI finance structure must include both programmatic reforms and an approach that ensures revenue stability. This should include aligning tax and benefit provisions to build and maintain a sufficient reserve. Under a "do nothing" scenario, California policymakers will continue to succumb to federal policies, and employers will continue paying higher and higher federal employment taxes. This, during a time when they also face tax increases from federal healthcare laws ("Obamacare"), California's Proposition 30 and Proposition 39, and a potential increase in the minimum wage.

Components of a comprehensive solution also should include:

- Setting benefits, eligibility requirements, and taxable wage and rate levels similar to neighboring states and national averages.
- A fair distribution of the increased tax burden, by applying a tax rate based on claims experience that would minimize sharp increases in costs for employers. The fair distribution also could include a requirement for employee contributions into the UI system (employees currently fund 100 percent of their state disability insurance).
- Increasing the system's integrity by enacting provisions to reduce UI claims fraud and eligibility errors, including improper overpayments (California's improper UI payment rate averaged 6.19 percent, and amounted to an estimated \$404 million in 2012).

While regular UI benefit payments are declining from the peak of the recession, the current financing system will not self-correct during better economic times because of the significant deficit (even if disbursement levels were to reach pre-recessionary levels).

Absent any meaningful reforms, the California Employment Development Department projects a \$9.9 billion deficit of the state's UI fund at the end of 2013, and a \$9.1 billion deficit at the end of 2014 ([EDD May 2013 UI Fund Forecast](#)).

California is not alone in its inability to support its UI program. Some similarly situated states have implemented measures to ensure the integrity of their UI funds. Some states reduced the number of weeks of eligibility below the 26-week period, and some tightened eligibility requirements. Some states have secured bonds, and most states impose an income tax on UI benefits (only six states – California, Maryland, New Jersey, Oregon, Pennsylvania and Virginia – fully exempt unemployment benefits from recipients' income taxes).

Some states require employees to share the cost of UI with employers (Alaska, New Jersey, and Pennsylvania require employees to make contributions to the UI fund). Other states also have implemented a multitude of eligibility, benefit, operational and administrative changes to secure a UI system that is fair, efficient and remains solvent even during the toughest of economic times. And some states, including California, have turned to the federal government for financial assistance.

There currently are 18 states that owe the federal government a combined \$19.8 billion. California began borrowing from the federal government in January 2009, and has an outstanding loan balance of \$8.7 billion as of August 20 (far outpacing the state with the next highest balance, New York, which has a \$2.5 billion debt).

Under federal law, when a state defaults on a loan from the federal UI account, employers must foot the bill to begin the repayment process. California defaulted in 2010.

The federal loan repayment by employers is done through a 0.3 percent per year Federal Unemployment Tax Act (FUTA) credit reduction. The FUTA credit reduction increases 0.3 percent every year until the loan is repaid.

For 2011, California employers saw a \$21-per-employee federal employment tax increase – a \$289 million hit on employers. When employers file their 2012 federal employment tax returns in 2013, they will see a \$598 million increase, and this will climb to \$895 million in 2014.

As part of the federal American Recovery and Reinvestment Act, interest owed on the federal loan was waived through December 31, 2010. Interest began accruing on January 1, 2011, and the resulting first two interest payments of \$303.5 million and \$308.2 million were made to the federal government on September 30, 2011, and September 30, 2012, respectively.

To pay the interest on the federal loan, state policy makers borrowed from the State Disability Insurance Fund. This loan must be repaid with interest within five years. An additional \$261.5 million interest payment is due September 30, and another \$238.5 million is due in September 2014.

The governor's administration is working with a broad coalition, including CalTax, with the goal of advancing a UI reform package that will be considered in the final weeks of the legislative session.