

The Path to Responsible Financing of California's Unemployment Insurance System

By Maurice Emsellem, Mike Evangelist, Claire McKenna

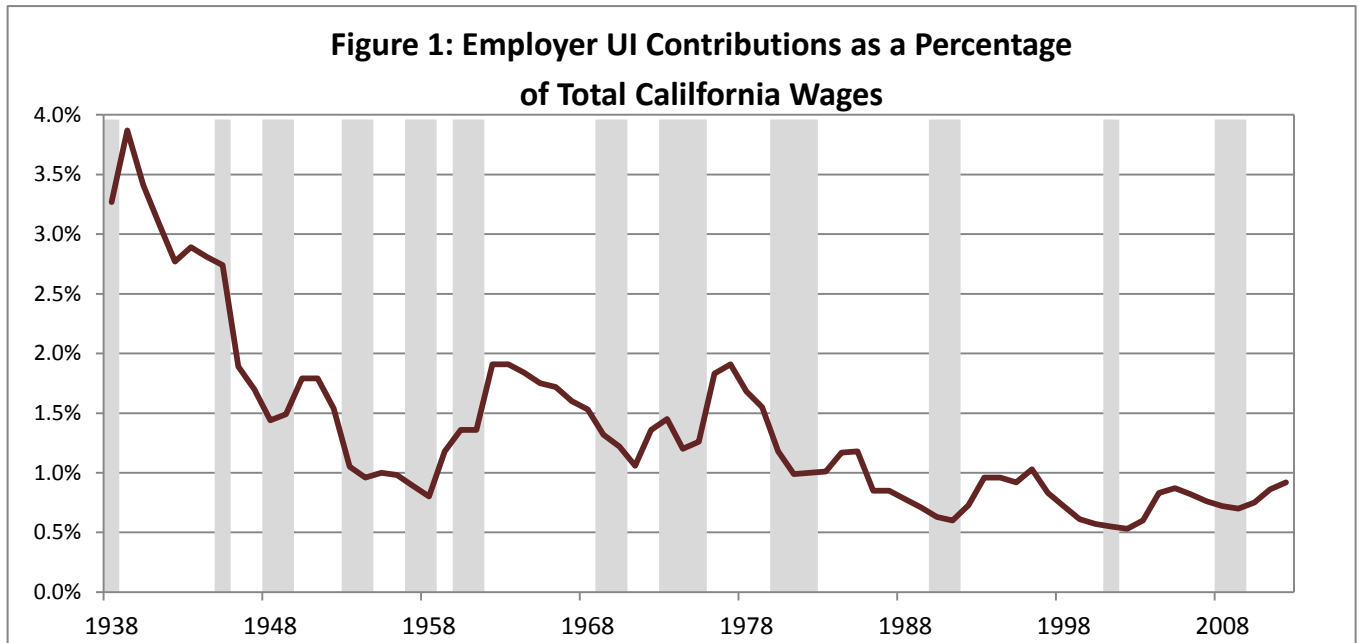
For over two decades, California's unemployment insurance system has failed to generate sufficient reserves to pay unemployment benefits during even a mild recession. Indeed, when jobs were plentiful and corporate profits soared during the Dot-Com Boom of the late 1990s, California's unemployment insurance trust fund still collected less revenue from employers than it paid out in state benefits.

Then the bottom fell out when the Great Recession hit in 2007, driving the unemployment rate to a peak of 12.4% in February 2010 and nearly doubling the number of workers collecting state benefits by 2009. As a result, California's unemployment system was one of the first in the nation to go bust (in January 2009), and it is now in debt to the tune of \$10.7 billion to the federal government to honor its obligation to pay the basic 26 weeks of state benefits. And that does not include the interest on the federal loans, which has already surpassed \$600 million, with almost \$600 million more coming due in 2013 and 2014.

The federal loan has produced serious fallout for California's employers, workers and taxpayers. Each year, California's employers are charged an additional \$21 per worker in federal unemployment insurance (UI) taxes until the loan is paid back (the federal tax has reached \$63 per employee, and it will increase to \$84 in January 2015). That's money that goes straight to the federal Treasury, not back into the state's unemployment trust fund to build up the state's reserves. Moreover, the state's taxpayers are on the hook to pay the interest on the federal loan, not the state's employers. That's because the Legislature borrowed money from the State Disability Insurance (SDI) fund, which is financed by California workers, to pay the \$600 million in federal interest thus far accumulated.

As most everyone agrees, this patchwork system is not sustainable to build the reserves necessary to pay benefits when the next recession hits, as it does on average every four years in California. As detailed in his 2013-2014 annual budget, Governor Brown has convened state officials, business and labor leaders to respond to the solvency crisis. The solvency crisis threatens the foundation of an invaluable program that has pumped nearly \$40 billion in hard cash into the state's struggling economy since the crash began in 2007 (not including \$20 billion more in federally-funded benefits paid in 2011-2012 alone) and supported millions of unemployed workers and their families hardest hit by the recession.

While the magnitude of the problem could not be more severe (California’s debt to the federal government represents over one-third of all the outstanding state loans), the specific causes of the crisis and the solutions are painfully clear. The simple fact is California pays especially modest unemployment benefits, while the state’s employers pay some of the lowest unemployment taxes in the state’s history. As illustrated below (Figure 1), the average UI taxes collected from California employers (calculated as a percent of total wages paid in the state) have fallen sharply in recent decades. During the last decade (from 2000-2009), California employers contributed just 0.70% of the total wages to the unemployment insurance trust fund, which is less than half of what they paid during the 1970s and far less than prior decades.



The unemployment insurance debt crisis presents a genuine opportunity to return to the basic insurance principles of the program, thus raising adequate revenue in good times, when payrolls are expanding, to pay adequate benefits and boost the economy when hard times hit. As detailed below, to achieve this goal, reform of the state’s unemployment financing system should include the following key elements:

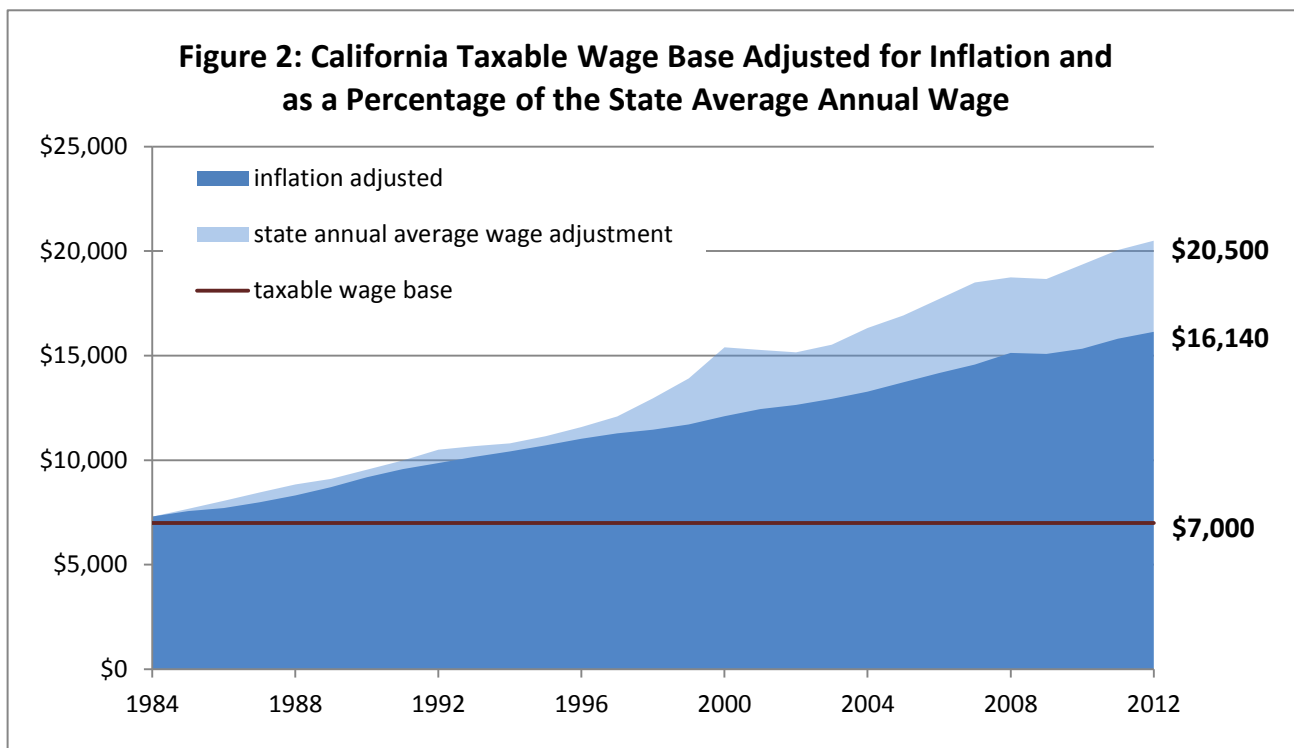
1. Raise the \$7,000 taxable wage base to \$17,500 to reflect inflation and wage increases since it was last increased in 1983 (most of the neighboring states average over \$25,000 and index their taxable wage base);
2. Increase the maximum tax rate of 6.2% to at least 8% to ensure that all the state’s employers contribute their fair share to the unemployment insurance trust fund;
3. Impose an emergency surcharge on employers to pay the \$600 million in interest on the federal loan for 2014 and 2015, which in 2011-2012 was financed from loans provided by the employee-funded SDI program; and
4. California should follow the lead of 33 states and index the state’s unemployment benefits to provide more adequate income to support unemployed families (California’s average benefits now rank 43rd lowest in the nation).

1. Raise the \$7,000 taxable wage base to \$17,500 to reflect inflation and wage increases since it was last increased in 1983 (most of the neighboring states average over \$25,000 and index their taxable wage base).

Federal law requires that every state collect payroll taxes from employers on at least the first \$7,000 of an individual’s earnings, but the states have complete discretion to impose a higher “taxable wage base” to raise sufficient revenue. The federal government last increased the minimum taxable wage base in 1983, when the federal minimum wage was still \$3.35 an hour.

The most salient deficiency in California’s unemployment insurance financing system is the fact that the taxable wage base has been stagnant at the federal minimum of \$7,000 since it was last increased three decades ago to comply with the federal law. Arizona is the only other state in the nation with a \$7,000 taxable wage base, while the taxable wage base of our other three neighboring states (Nevada, Oregon and Washington) averages \$32,500 between them. Like 15 other states, these three states also index their taxable wage bases to account for rising wages.

Of course, what passed for an adequate threshold in 1983 bears no resemblance to the current realities of California’s employers. In 1984, the \$7,000 taxable wage base represented 36% of California’s average annual wage, while today it represents just 12.7% of the state’s average wage. The travesty of this antiquated regime is that it’s not only irresponsible financing policy, but it’s also profoundly inequitable because the system is being subsidized by the state’s low-wage workers and their employers while the highest wage employers fail to contribute their fair share to the unemployment trust fund.



As depicted in Figure 2, if California's taxable wage base had maintained its value since 1984, it would now be substantially higher, thus generating far more revenue from all employers across a broader wage spectrum. When adjusted for inflation, California's taxable wage base would be about \$20,500 today, and when adjusted to reflect the increase in wages in California, it would be \$16,140, or more than twice the current amount.

Accordingly, we recommend that the California's taxable wage base be raised to at least \$17,500, which would represent about 32% of the average annual wage in the state. It's a modest measure in the sense that it would align California with the national average of \$16,700, although it is still below the amount required of most of California's neighboring states. In addition, like our neighboring states, the taxable wage base should be indexed to reflect future increases in wages and achieve greater equity across higher- and lower-wage employers.

2. Increase the maximum tax rate of 6.2% to at least 8% to ensure that all the state's employers contribute their fair share to the unemployment insurance trust fund.

The revenue generated by unemployment insurance payroll contributions is a function not just of the amount of wages taxed (i.e., the taxable wage base), but also of the rate at which the wages are taxed. In California, the rate varies from a minimum of 0.1% to a maximum of 6.2%, depending on the individual employer's history of layoffs (called "experience rating") and the health of the state's unemployment insurance trust fund.

Thus, the minimum a California employer can pay each year in state UI taxes is \$70 per worker (.01% x \$7,000) and the most an employer can pay is \$434 per worker (6.2% x \$7,000). In 2012, the average employer contributed \$378 per worker in UI taxes. California has been at the highest tax rate of 6.2% since 2004, well before the recession began. In addition, all the nation's employers pay a federal UI tax of \$42 per worker to fund the federal extensions and the costs of administering the state UI programs.

Only Florida's employers pay slightly less (\$432) per worker than California employers at the maximum tax rate. Most of California's neighboring states pay upwards of three to six times what California employers pay at the highest tax rate. (Nevada employers pay \$1,426 per worker for employers at the maximum tax rate and \$610 on average; Oregon employers pay \$1,782 per worker for employers at the maximum tax rate and \$1,007 on average; and Washington's employers pay \$2,231 per worker for employers at the maximum tax rate and \$676 on average).

What's unique about California, and has been for many years, is the fact that a disproportionately large percentage of the state's employers reach the maximum tax rate. Indeed, in 2012, 47% of all California employers were paying at the maximum take rate of 6.2%, which is nearly double the percentage of the closest state, Michigan (27%). That's a compelling indicator that the maximum rate is artificially low. Thus, it should be increased to generate adequate revenue and more fairly distribute the tax incidence across all the state's employers.

The U.S. Department of Labor (DOL) has developed a helpful indicator to measure whether the maximum tax rate of a state is sufficient to produce the revenue necessary to pay benefits during a

severe recession and repay its federal loans.¹ According to DOL's "adequate financing rate," California's average tax rate would need to nearly double (to 10.14%) to pay back the loan and raise sufficient revenue to pay benefits in the inevitable event of another recession.

About half the states have maximum tax rates that exceed 7%, including 20 states that are above 8% and nine states where the maximum tax rate exceeds 9%. Given the extreme accumulation of California employers paying the maximum tax rate in California, we recommend that the rate be increased to at least 8%. At an 8% maximum tax rate and a \$17,500 taxable wage base, California employers paying at the highest tax rate would still be contributing less in taxes (\$1,400) than employers in the neighboring states of Nevada, Oregon and Washington.

3. Impose an emergency surcharge on employers to pay the \$600 million in interest on the federal loan for 2014 and 2015, which in 2011-2012 was financed from loans provided by the employee-funded SDI program.

While the UI debt crisis in California is the direct product of record low unemployment taxes paid by the state's employers, it is the average worker and taxpayer who now foots the bill to pay over \$600 million interest that has thus far accumulated on the federal loans.

Specifically, in both 2011 and 2012, the California Legislature decided to take out separate five-year loans from the employee-financed SDI fund to pay back the interest on the federal UI loan. In 2016 and 2017, California taxpayers are on the hook to pay back the SDI loan, thus diverting \$600 million in general revenue from other compelling budget priorities now facing the state, including major cuts to public services. Currently, the Legislature is debating a proposal to pay the estimated \$291 million in federal interest due in 2013 directly from the state treasury, thus bringing the total to nearly \$900 million in interest payments charged to the state's taxpayers, not the state's employers.

We strongly support the Governor's 2011 proposal to create a special assessment on employers to finance repayment of the interest on the federal loan. Twenty-two states already have enacted some form of interest assessment, which produces funding that is segregated from the state UI trust fund. Financing of the unemployment insurance trust fund is an employer responsibility, not the responsibility of the state's hard-working taxpayers.

4. California should follow the lead of 33 states and index the state's unemployment benefits to provide more adequate income to support unemployed families (California's average benefits now rank 43rd lowest in the nation).

Finally, if the state's unemployment insurance program is to continue to provide an effective boost to the state's economy when hard times hit, it is also critically important to maintain adequate state benefits.

¹ For more detail on the "adequate financing rate" described above, and additional state-by-state data on UI tax and financing, see U.S. Department of Labor, Office of Unemployment Insurance, Division of Fiscal and Actuarial Services, [Significant Measures of State Unemployment Insurance Tax Systems](#) (2012).

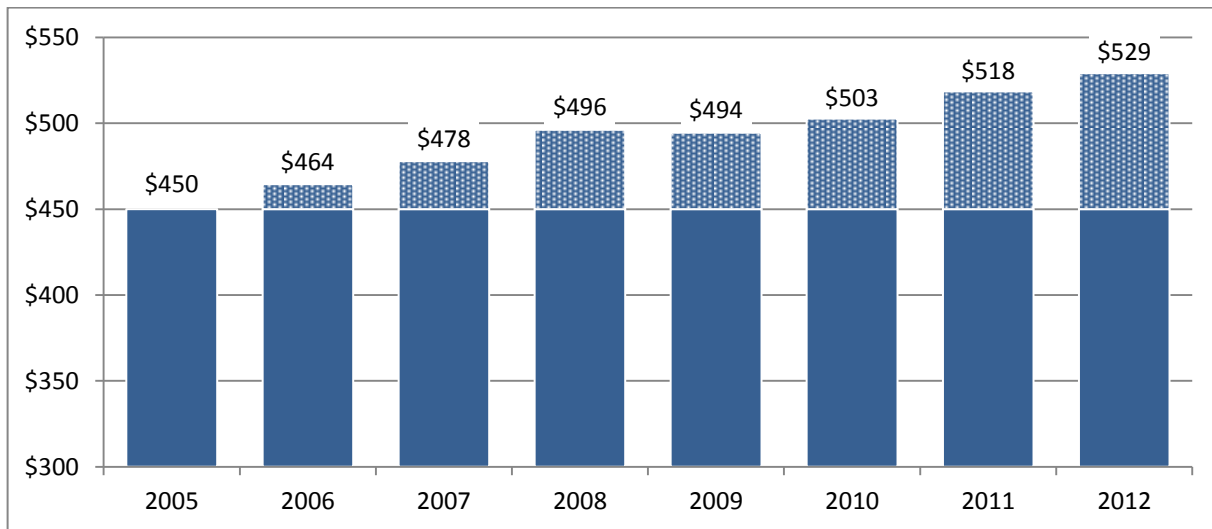
The fact is that California's benefit levels rank 43rd lowest in the nation and the value of the state's benefits are progressively falling behind because the benefits are not indexed to take into account the cost of living and wage increases. The minimum weekly benefit in California is \$40 and the maximum weekly benefit is \$450. Unlike over a dozen other states, California does not provide any additional benefits for families that support dependent children and adults with special needs.

The average unemployed Californian receives \$294 in benefits each week, which replaces just 27.6% of the state's average weekly wage. Based on this standard measure for comparing the adequacy of unemployment benefits across the states, only six states (Louisiana, Arizona, Delaware, New York, Alaska, and Alabama) provide less in benefits to the average unemployed worker than California. \$294 in weekly unemployment benefits is hardly enough for an unemployed family to cover rent for an average apartment, especially in the state's high-cost urban areas.

The challenge of living on unemployment benefits in California has become even more severe because of the recent federal sequester of federally-funded Emergency Unemployment Compensation (EUC). In California, EUC benefits were reduced by 17.7%, which translates into a cut of about \$50 a week for the average unemployed worker, and \$80 a week for those collecting the maximum \$450 weekly benefit amount. Still, these modest benefits contribute greatly to the state's economy, especially in those distressed communities in the Central Valley and are areas of the state where unemployment rates that still exceed 15%.

And because the state's benefits were last increased in 2004, workers are able to buy less and less with their modest unemployment checks. In fact, since 2005, the value of the state's maximum weekly benefits of \$450 has declined by 15% due to inflation, or by \$67. As illustrated below (Figure 3), to maintain its purchasing power, the state's maximum benefit would have had to increase to \$529 by 2012.

Figure 3: The Stagnating Value of California's Maximum UI Benefit (in 2012 dollars\$)



Source: U.S. Department of Labor, ETA, UI Reports Handbook 401 and BLS, Consumer Price Index All Urban Consumers (CPI-U)

To prevent California from falling to the bottom of the pack nationally, the time has come for California to join the other 33 states in the nation that index their benefits to reflect wage increases. These measures could be phased in over time as the state's economy improves and the number of workers claiming UI benefits decreases.

Although a modest measure, indexing the state's UI benefits will help California's workers and their families cover their basic necessities while also providing a boost to the state's economy when the next recession hits. Federally-financed extended benefits, which are routinely enacted during major recessions, are paid at the same rate as the state's benefits. Thus, by enacting a modest increase in the state's benefits, California will be able to leverage far more in federal funding to help reignite the state's economy during the next severe downturn.