UI Trust Fund Deficit Continues into 2018; Employer Federal Tax Increases Again

The Problem

Because of unemployment insurance (UI) benefit increases adopted by the Legislature in 2001 without a revenue adjustment, California landed quickly in debt to the Federal Unemployment Trust Account (FUTA) in 2009 during the Great Recession. California's UI Trust Fund continues for the eighth straight year to be in debt to the FUTA. With an outstanding debt forecast at $3.9 billion at the end of 2016, California remains the only state, other than the U.S. Virgin Islands, carrying debt to the federal fund. California's negative balance is projected to decrease to $1.1 billion by the end of 2017, and to be paid off sometime in 2018, if the economy continues as predicted and if changes are not made to the structure of the state's UI system.

As a result of the state debt to the FUTA and as required by federal law, California employers are paying a higher federal UI tax in order to pay down the debt. Each year that a balance is owed to the federal fund, California employers pay 0.3 % higher federal UI tax and the state must pay interest on the outstanding debt. It is projected that by the end of 2018, employers will have paid an additional $9.6 billion in increased FUTA taxes and the state will have paid more than $1.4 billion in interest on the loan.

The normal annual federal UI tax on employers is $42 per employee (0.6% on the first $7,000 in wages each year), but because of the debt to the federal trust fund, the tax is increasing by $21 per employee, per year until the debt is eliminated. The federal UI tax to be paid by employers in California for 2015 was $126 per employee. The maximum federal tax for 2016 was $147 per employee, and in 2017 (potentially the final year the state will be in deficit) it is projected to be $168 per employee (see computation of federal tax in table "Cumulative UI Tax Increases as Long as California Owes Federal Unemployment Debt"). FUTA taxes are due January 31 of the year following the year in which the taxes are applied. The federal UI tax is in addition to the state UI tax (state maximum 6.2% on the first $7,000 of wages per employee), and goes directly to pay down the state's debt to the federal UI fund.

Background

Through federal and state cooperation, UI benefits act as a stabilizer during economic downturns by providing a source of temporary, partial wage replacement for workers who have become unemployed through no fault of their own and are looking for employment. Under current state law, weekly UI benefit amounts are intended to replace up to 50% of a claimant's wages, based on a formula, up to a maximum of $450 per week for up to 26 weeks, depending on eligibility. To induce states to enact UI laws, the Social Security Act of 1935 provided a tax offset incentive to employers and authorized grants to states to meet the costs of administering the state systems. Employers receive an offset against federal taxes if state UI programs meet certain requirements, including fully funding benefits for state claimants.

Aside from federal standards, each state has primary responsibility for the content and development of its UI law. The state itself decides the amount and duration of benefits (except for certain federal requirements concerning federal-state extended benefits); the contribution rates for employers (with limitations); and, in general, the eligibility requirements and disqualification provisions to collect benefits. The states also directly administer the programs collecting payroll taxes, maintaining wage records, taking claims, determining eligibility, and paying benefits to unemployed workers.

One federal requirement is that all contributions collected under state laws be deposited in the Unemployment Trust Fund (UI Trust Fund) of the U.S. Treasury Department. States withdraw money from their account in the trust fund exclusively to pay UI benefits. Private plans may not be substituted for the state plan.

Funded by Taxes on Employers

California's UI program is funded exclusively by employers, from taxes on wages paid by employers, with the exception of temporary federal grants for administration, and certain emergency and extended benefits that have been paid from federal general revenue. The State of California administers its UI program through the Employment Development Department (EDD) within the guidelines established under federal law.

In addition to federal UI taxes, California employers pay state taxes on the first $7,000 in wages paid to each employee during a calendar year. Each employer pays a tax rate based in part on the amount of benefits that have been paid to former employees, so the tax is partly experience rated. Employers that have fewer claims generally are rewarded with a lower tax rate. Because the California UI Trust Fund has been facing financial difficulties for some time, however, all employers in California are paying taxes under the highest rate schedule allowable under state law, plus a 15% solvency surcharge, which makes California the highest state UI tax rate at 6.2%, plus the regular federal UI tax, and the additional federal tax component that goes to pay down the debt.

Loss of Federal Tax Credits Results in Higher Taxes on Employers

The federal UI tax normally due on wages paid by employers is 6%, offset by a 5.4% credit in states that comply with federal UI laws, resulting in a payable rate of 0.6% on wages up to $7,000

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Cumulative UI Tax Increases as Long as California Owes Federal Unemployment Debt

	Annual Federal Tax*					
Tax Year	Regular FUTA Tax After Offset Credit	Percent Increase (+ 0.3% per year)	Tax Increase Per Employee (+$21 per year)	Total FUTA Tax Per Employee (Regular FUTA 0.6% + % Offset)	Total FUTA Tax Per Employee (Regular FUTA $42+ $ Offset)	Total FUTA Tax Increase Statewide (in year paid)
2011	0.6	0.3	$21	0.9	$63	$292,585,000
2012	0.6	0.6	$42	1.2	$84	$606,442,000
2013	0.6	0.9	$63	1.5	$105	$946,395,000
2014	0.6	1.2	$84	1.8	$126	$1,317,361,000
2015	0.6	1.5	$105	2.1	$147	$1,733,304,000
2016	0.6	1.8	$126	2.4	$168	$2,162,599,000
2017	0.6	2.1	$147	2.7	$189	$2,563,834,000
2018	California is not projected to have a FUTA credit offset reduction for tax year 2018.					

Cumulative Projected Total Increase of FUTA Tax on Employers for Tax Year 2011 through 2017 = $9,622,460,000

*Tax computation reflects the amount an employer pays on the first $7,000 of wages per employee in a year. Note: Increased FUTA taxes for a given tax year are payable during the following calendar year (for example, 2011 increases were payable beginning in January 2012).

a year. Employers receive the credit when the state program is in compliance with the federal UI program rules. The federal statute requires the federal government to incrementally reduce the offset credits to employers in states that do not timely repay their federal unemployment trust fund loans.

Due to California's outstanding debt, California employers are subject to a credit reduction that results in an employer-paid federal tax increase on wages paid. Since January 1, 2011, California employers have been paying higher taxes because the state has not repaid money it borrowed from the FUTA to pay UI benefits since 2009. The higher tax is projected to continue to increase in 2017 and potentially 2018 while the state retains an outstanding loan balance.

The table illustrates the FUTA tax increase and the cumulative impact on California employers from 2011 through 2017. The tax will continue to increase 0.3% per year (approximately $21 per year per employee who makes $7,000 per year) until such time as the loan is paid off and the state trust fund has a zero or positive balance as of November 10 each year.

It is projected that the debt will be paid off before November 10, 2018, so that the credit would be fully restored to employers for tax year 2018.

EDD projects that at this rate of increasing FUTA taxes—and absent any change to the revenue or projected payment of benefits—the debt to the federal trust fund will be paid off in 2018; thus employers' federal UI tax rate will be returned to 0.6% for tax year 2018. Keep in mind, the tax due for 2017 will be due in January 2018. This projection also assumes that the unemployment rate will decrease to 5% in California by 2017.

These projections are subject to change over time.

Unemployment Levels Higher than National Rate

California's total unemployment rate has decreased to 5.5%, from 7.5% in 2014—significantly lower than the high of 12.1% in 2010. The rate increased steadily from 2006 to 2011 before beginning a gradual reversal. California's rate of unemployment is higher than the national rate of 4.7% (U.S. Bureau of Labor Statistics).

The large increases in the ranks of the unemployed, coupled with benefit increases in 2001, led to a dramatic increase in expenditures from the UI Trust Fund. Benefits paid out are finally trending downward, however, SB 3 (Leno; D-San Francisco) signed by Governor Edmund G. Brown Jr. and chaptered in 2016, increases California's minimum wage and is anticipated to increase benefit payout (reflected in forecast benefit payout). The regular UI benefit payments were $5.4 billion in 2015, and were forecast to be $5.4 billion in 2016, $5.5 billion in 2017, and $5.6 billion in 2018.

From 2001 to 2012, California's total benefit costs exceeded its revenue in all but two years. From 2014 through 2017, the fund revenue is expected to exceed benefit payout and begin to build a reserve.

UI Fund Insolvency

California, like the U. S. Virgin Islands, is struggling with a UI Trust Fund insolvency resulting from sudden and severe increases in unemployment associated with the worldwide recession. California's UI Trust Fund technically became insolvent in January 2009, and by November 2009 the state had borrowed more than $5.5 billion from the federal unemployment fund in order to pay benefits to California's unemployed. As of September 2012, outstanding federal loans to 28 states totaled $37 billion, with California comprising more than 27% of the total. At the end of 2012, California's outstanding federal loan was $10.2 billion, more than $6.5 billion greater than the next highest state loan, New York. By the end of 2016, California's loan is projected to have contracted to $3.9 billion due to increased federal taxes on employers (which are applied to the loan balance) and a lower payout of benefits.

California has taken by far the largest loan. In 2011, 10 states had loans exceeding $1 billion (but less than $2 billion). Eight states eliminated their outstanding debt in 2014, and an additional five states eliminated their debt in 2015. The remaining states—Connecticut and Ohio—eliminated debt in 2016, leaving only California and the U. S. Virgin Islands with debt. Tax-exempt bonds were used to restructure the debt before 2014 in seven states: Idaho, Texas, Michigan, Nevada, Pennsylvania, Illinois and Colorado. The other five states either utilized special funds or addressed solvency issues early in the year and did not have deficits as high as other states. In 2015, UI debt was eliminated by five states—Indiana, Kentucky, New York, North Carolina and South Carolina—all of which cut benefits and/or raised taxes. No states issued bonds to eliminate UI debt in 2014 through 2016.

Compared to other states, California's benefit eligibility requirements are more generous, requiring a lower attachment to the workforce, which further stresses the state's benefit payout. Continual borrowing has serious consequences for the state, particularly in the form of ongoing interest payments and increases in the effective federal UI tax rate on California employers.

Insolvency Factor

California's current UI fund insolvency is caused not only by significant unemployment, but also can be traced back to the UI benefit increases imposed in 2001. The California Chamber of Commerce opposed this increase in benefits because it was not coupled with cost savings. Further exacerbating the situation, as unemployment and duration of benefits increased during the recent recession, the state collected fewer tax revenues and paid more benefits to unemployed Californians.

With the annual UI benefit obligation projected to be around $5.4 billion in 2016 and $5.5 billion in 2017, California can expect its UI Trust Fund to be in debt about $1.1 billion to the federal trust fund by the end of 2017. If California's economy continues to improve as anticipated while generating sufficient UI tax receipts to pay ongoing benefits, the principal debt will be paid off in 2018 and the FUTA offset credit will be fully restored to employers for the tax year 2018.

UI State Reform and Policy Outlook

The UI situation in California remains unchanged—its federal UI tax is going up, the state remains in debt to the federal UI trust fund and unemployment levels higher than the national average may continue through the next few years. With the end of the UI Trust Fund debt in view, bringing an end to the increased federal tax on employers, it is likely that the state may examine the potential for UI tax increases on California employers along with system and integrity reforms. California's UI system would be difficult to address with simple changes to the base UI tax system or benefit cuts.

If changes are to be made, a combination of long-term and short-term strategies must be considered as a package to resolve California's long-term outlook. Increased taxes could harm the economy and therefore must be kept to a minimum. Any potential change to the UI system must include improved system efficiencies, enhanced opportunities for employers to manage claims effectively, and the appropriate alignment of benefits and benefit eligibility with workforce attachment in order to manage and maintain a prudent reserve while keeping any increase in taxes to a minimum.

CalChamber Position

The CalChamber believes that the state must be diligent in its policy making to improve the business climate in California and create more jobs, while striving to combat increased unemployment and seeking a more stable UI Trust Fund.

The UI system cannot be viewed in isolation from the overall business climate in the state and in surrounding states that compete for California businesses. The state needs a sustainable UI system that protects both workers who are temporarily unemployed through no fault of their own, and employers who spur investments and job creation.

Any solution to resolve the ongoing deficit, to prevent further debt to the federal trust fund and to return the California UI fund to stability must make significant changes to improve system integrity (including dealing with fraud and overpayments); encourage and facilitate the ability of employers and the state to appropriately address claims; and update eligibility determinations in line with today's wages. Both tax and benefit levels must be consistent with those of other states so that California remains competitive to attract and retain businesses.

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