Unemployment Insurance Fund

State Funding Commitment Needed to Offset Pandemic-Induced Insolvency

Through federal and state cooperation, unemployment insurance (UI) benefits act as a stabilizer and safety net during economic downturns by providing temporary, partial wage replacement for workers who have become unemployed through no fault of their own and are looking for employment. To induce states to enact UI laws, the Social Security Act of 1935 provided a tax offset incentive to employers, if a state UI program complies with federal requirements, including fully funding benefits for state claimants.

In addition to maintaining federal standards, each state has primary responsibility for the content and development of its UI laws and administration of the program. California administers its UI program through the Employment Development Department (EDD).

BACKGROUND: HOW EMPLOYERS FUND THE PROGRAM

California's UI program is funded exclusively by employers, via state and federal taxes on wages. The only exceptions to this rule are temporary federal grants for administration and certain emergency and extended benefits that have been paid from federal general revenue — some of which were utilized during 2020 in response to COVID-19 and are discussed below. Employees do not pay any UI taxes.

Employer contributions are deposited in the Unemployment Trust Fund (UI Fund) of the U.S. Treasury Department. States withdraw money from their accounts in the trust fund exclusively to pay UI benefits. If a state trust fund does not have adequate funds to pay benefits, a loan is made from the federal fund so that all claims are paid.

Generally, the federal UI tax is fixed at 6% of wages up to $7,000 per year per employee for all employers in the state (FUTA taxes), offset by a 5.4% credit in states that comply with federal UI laws (FUTA tax credit), resulting in a payable rate of 0.6%. Assuming the state is in compliance and the state's UI Fund is solvent, this comes to $42 per employee per year. FUTA taxes are due January 31 following the year in which the taxes are applied (for example, 2022 taxes are due January 31, 2023).

If a fund remains insolvent for two consecutive years, then FUTA tax credits are reduced annually and cumulatively by 0.3 percentage points until the fund returns to solvency, creating a steadily growing tax increase on the state's employers.

COVID-19 AND UNEMPLOYMENT INSURANCE

COVID-19 and the related economic shutdown brought UI policy to the forefront in California and nationally. As COVID-19 crashed across the nation, and businesses complied with state-mandated safety precautions and shutdowns, unemployment rapidly rose to levels not seen since the Great Depression. In just two months, from March to May 2020, the unemployment rate in California rose from 5.5% to 16.1%. Unemployment insurance was used to backfill this economic crater, keeping food on the table for many Californians and providing critical stability to the economy.

Unlike prior recessions (such as the recent Great Recession), entire sectors of the economy were forced to shut down or operate at severely reduced capacity, due to self-isolation by customers, mandates from government, or broken supply chains. This meant many employers were compelled to terminate much or all of their workforce, and then pay unemployment compensation for this compelled termination.

Although the economy has largely reopened, some businesses (particularly the greatly diminished restaurant and hospitality sectors) continue to struggle to rebuild. For employers, including those that have fully re-employed their

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AUTOMOBILE CLUB • SOUTHERN CALIFORNIA • AAA workforce, the considerable UI Fund debt that arose during the pandemic remains outstanding.

The question in front of California policymakers is: given that the present debt was caused largely by a collapse of the economy from a global pandemic and California forcing employers to shut down on a statewide scale, how can the state help fix the present insolvency of the UI Fund and prevent tax increases on California employers?

By November 9, 2020, California had accumulated $15.7 billion in debt, and debt peaked in late 2021 at approximately $20 billion. By the end of 2022, that debt remained at a staggering $18.4 billion — more than twice the next highest state (New York with less than $8 billion in debt).

BUDGET ACTIVITY IN 2022 AND ONGOING NEED FOR ASSISTANCE

Heading into 2022, many other states — led by both Democrats and Republicans — had used federal or state moneys to pay down their UI Fund debts and help avoid tax increases on employers. Those states included Delaware ($209 million), New Hampshire ($50 million), Massachusetts ($181.8 million), Georgia ($1.5 billion), and Hawaii ($3.4 million). As late as November 2021, the Texas legislature allocated $7.1 billion of its CARES Act funds to fully repay its remaining insolvency.

Although California had given no aid to the UI Fund in 2020 or 2021, California appeared on the cusp of making a significant contribution to reduce the debt in the 2022 budget with a significant budget surplus of nearly $100 billion. Governor Gavin Newsom proposed a direct payment of $3 billion to help with the UI Fund's insolvency in his initial proposal and May Revision. In addition, Assemblymember Tom Daly (D-Anaheim) proposed AB 2570, supported by the California Chamber of Commerce, which would have committed $7.25 billion to reducing the debt. Despite support for restoring the solvency of the UI Fund from numerous legislators in both parties, the amount of aid was reduced significantly in the final budget. The 2022 budget contained a small and short-term commitment to aiding the UI Fund, comprised of two parts:

- Two small payments toward the UI Fund insolvency, with $250 million in the 2022–2023 budget, and a commitment to an additional $750 million in 2023–2024.
- A commitment to allocate $500 million in the 2024–2025 budget to provide tax breaks to small businesses to compensate for a portion of the unemployment-related tax increases those businesses will face.

Most of the 2022 budget's aid was comprised of future commitments — with $750 million in 2023–2024, and tax relief in 2024–2025. However, the Governor's initial 2023–2024 budget proposal did not include these critical funds. It remains to be seen if any will be added back in the coming months and what will actually materialize in the 2024–2025 year.

2023 AND BEYOND: TAX INCREASES AND RECESSION CONCERNS

Because the UI Fund remained insolvent for two years, employers across California will suffer a payroll tax increase in 2023 by $21 per employee. The tax will continue to rise by this amount every year until the debt is repaid to the federal government. It is hard to speculate how many years this will take — but the Great Recession provides a useful comparison.

During the Great Recession, California's UI Fund bottomed out at $10.3 billion in debt. This was a record at the time, and was *not* a result of a statewide shutdown, but a result of a financial panic and other economic factors. The subsequent recession created massive unemployment, but nothing compared to the rapidity and extent of the pandemic economic crisis. Employers paid elevated per-employee taxes from 2011 to 2017, when the fund returned to solvency.

Presently, the UI Fund is significantly deeper into debt, with a total debt of $18.4 billion heading into 2023. Assuming no federal or state relief, California employers will face an increased tax burden on a per-employee basis — which will disincentivize hiring — for years to come. Although the duration of the debt (and increased taxes) will depend on economic circumstances and workforce participation, we estimate that California employers will likely pay increased UI taxes through the year 2030.

What does that look like for a normal employer, as opposed to pre-pandemic times? In a normal year, employers pay $42 per employee for the UI Fund (with some adjustment depending on their past experience and industry). In 2023, an employer will pay $21 more per employee, or $63 per employee … then $84 in 2024, and $105 in 2025. Looking down the road to 2030, employers may be paying $210 per employee in FUTA taxes — an increase of 400% over a normal year.

There also is considerable concern about a nationwide recession, with significant belt tightening at the federal level throughout 2022 to confront inflation. Should a recession develop, California employers will be even less able to absorb these tax increases, and decreased labor force participation (as businesses contract or close) will mean that California's UI Fund may remain in debt even longer.

EDD CAPABILITIES AND FRAUD CONCERNS

The unprecedented surge of unemployment applicants caused by the state-mandated economic shutdowns also laid bare the technological and logistical shortcomings in the EDD. Outdated technology and organizational bottlenecks around claims processing caused a huge backlog of applications, with some claimants waiting months for their claims to be processed. The EDD also failed to catch significant fraud due to its rush to distribute benefits. EDD estimates that California paid around $20 billion in fraudulent payments, with at least $1 billion coming from California's UI Fund, although the Legislative Analyst's Office recently asserted that it disputes this number and believes the total fraud attributable to California's fund is lower.

Regardless of the exact amount, the core issue for California employers is the same: when EDD makes mistakes in its distribution of funds (either through fraud or unintentional overpayments), employers end up paying the bill to replace the mistakenly distributed funds. As a matter of fairness, EDD must take proactive steps to improve its distribution process and minimize fraudulent (or mistaken) distribution of benefits.

A slew of legislation from both parties aimed to increase fraud detection and improve practices at the EDD during the 2022 legislative session. Notably, AB 110 (Petrie-Norris; D-Laguna Beach) passed and allowed for improved information sharing to prevent fraud by inmates in California's penal system. In addition, SB 390 (Laird; D-Santa Cruz) will compel the EDD to create a recession plan to improve future performance. Although this legislation is an improvement, employers remain concerned with EDD's ability to distribute benefits accurately to deserving recipients.

CALCHAMBER POSITION

Unlike in the Great Recession or in normal times, the massive unemployment in 2020 and 2021 was not the result of the business cycle or business decisions made by individual employers. A global pandemic caused customer insecurity and state and local shutdown orders, which directly led to job terminations. Similarly, employers had no ability to prevent the EDD's mismanagement of fraud detection during the pandemic.

California's policymakers must acknowledge this partial responsibility in creating the unprecedented insolvency of California's UI Fund and should, following the lead of other states, help restore the solvency of the fund.

Although the 2022–2023 Budget began this process, it was mostly future commitments and was altogether too little to materially affect the fund's condition. The CalChamber supports future proposals to reduce the UI Fund's insolvency and mitigate future employer tax increases.

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