



Hearing on UI Solvency - UWC Testimony

House Ways and Means Subcommittee Chairman Jim McDermott (D-WA) held a hearing on May 6th on the solvency of state unemployment insurance trust funds. This hearing was the first step in developing federal legislation that may include new federal requirements for state unemployment trust fund solvency. A GAO study of the current insolvency of the system was a key part of the hearing.

In announcing the hearing, Chairman McDermott released the following statement:

The unemployment insurance (UI) system, established by the Social Security Act of 1935, aims to provide partial compensation for the lost earnings of workers who become unemployed through no fault of their own and help stabilize the economy during downturns by supporting consumer demand. Federal law establishes the basic parameters of the UI system, but each State designs its own program within this framework. States assess taxes on employers to support the payment of regular unemployment benefits, while a federal tax finances UI administrative costs, half of the costs of the permanent law Extended Benefits (EB) program, and loans to States.

The UI system was designed to be forward funded, with States building up reserves during periods of economic expansion to be able to pay out more benefits during economic downturns. However, many States failed to build sufficient surpluses before the recession that began in December of 2007. The lack of adequate reserves combined with the severity of the recession has left the UI system in its weakest financial condition in many decades, perhaps even since the inception of the program. To date, 34 States have been forced to borrow money from the federal government in order to pay regular unemployment benefits. By 2012, States are projected to have outstanding loan balances of roughly \$90 billion.

"We have seen firsthand how vitally important unemployment insurance is to individual workers and to our entire economy. It is the difference between hardship and complete destitution and the difference between a bad recession and a devastating depression. Unfortunately, prior to the recession, many States did not build anything close to adequate reserves in their UI trust funds to respond to increased need during hard times. Moving forward, we need to find ways to help States restore solvency to their unemployment insurance programs so they can continue to pay needed benefits to workers who have lost their jobs through no fault of their own."

In its testimony UWC requested relief from FUTA tax penalties, while noting that a review of the system should include examination of benefit expansions in recent years as well as state and federal tax policy. A copy of the testimony is attached.

Testimony of Douglas J. Holmes
President, UWC- Strategic Services on Unemployment &
Workers' Compensation

Before the
Committee on Ways and Means
Subcommittee on Income Security and Family Support

Hearing to Assess the Solvency
of
State Unemployment Insurance Programs

May 6, 2010

UWC- Strategic Services on Unemployment & Workers' Compensation
910 17th Street, NW, Suite 315, Washington, D.C. 20006
Phone (202) 223-8904 Fax (202) 783-1616 www.UWCstrategy.org

Chairman McDermott, Ranking Member Linder, and members of the committee, thank you for the opportunity to testify this morning.

I am Douglas J. Holmes, President of UWC- Strategic Services on Unemployment & Workers' Compensation (UWC). UWC counts as members a broad range of large and small businesses, trade associations, service companies from the Unemployment Insurance (UI) industry, third party administrators, and unemployment tax professionals. The organization traces its roots back to 1933 at the time when unemployment insurance was first being considered for enactment.

By most technical economic measures the great recession of 2008-2009 is over. Initial unemployment claims are trending down, mass lay-offs have been reduced, and there has been some employment growth in certain sectors of the economy. Yet, the total unemployment rate remains in the 9.7% range.

The most effective way to improve the solvency of unemployment trust funds is to adopt measures that create the environment in which employers are willing to take a risk that the demand for goods and services will improve and revenue will be sufficient to cover the additional costs of employment. Increasing employment levels not only reduces benefit payout from unemployment trust funds but also increases tax revenue through the collection of additional federal and state unemployment payroll tax.

The confidence among employers needed to hire workers is not yet where it needs to be. Employers are reticent to create new jobs or rehire employees because of the uncertainty and size of payroll tax burdens. In a report on April 13, 2010, the National Federation of Independent Business released the results of its Index of Small Business Optimism for the month of March, in which the index lost 1.2 points, falling to 86.8. NFIB chief economist Bill Dunkelberg noted that "Something isn't sitting well with small business owners. Poor sales and uncertainty continue to overwhelm any other good news about the economy."

While actual job reductions may have halted, plans to create new jobs remain weak. The results of the March survey of NFIB members, compared to the February survey showed that over the next three months, 7 percent planned to reduce employment (down one point), and 15 percent planned to create new jobs (up two points), yielding a seasonally adjusted net negative 2 percent of owners planning to create new jobs, weaker than February and still more firms planning to cut jobs than planning to add. Only nine percent (seasonally adjusted) reported unfilled job openings, down two points and historically low, showing little hope for a lower unemployment rate.

PROVIDE FEDERAL UNEMPLOYMENT TAX PENALTY RELIEF

Immediate action is needed to provide relief from FUTA penalties to improve the outlook of employers making decisions about hiring.

The waiver of interest on loans to states to pay unemployment compensation should be extended through 2012—helping states and employers in the short term to plan to restore solvency and to implement solvency legislation within a reasonable timeframe. At least 35 states and as many as 40 states are projected to owe Title XII interest for the period beginning January 1, 2011 if no action is taken.

FUTA offset credit penalties should be waived through 2011. If no action is taken, employers in Michigan will pay an additional \$42 per employee for 2010 and an extra \$63 per employee for 2011. Employers in Indiana and South Carolina will pay an additional \$21 per employee for 2010 and \$42 per employee for 2011. A projected 25 states will pay a FUTA offset penalty for 2011, just at the time when job creation is essential to assuring economic recovery.

The FUTA offset credit penalty and Title XII interest both were designed as sanctions to penalize states that chose not to maintain solvent state UI trust funds. In normal periods these sanctions may be justified, however, in the current instance the size and duration of the recession could not have been anticipated and the period of time to respond was too short. The fact that 35 states and jurisdictions are already borrowing and up to 40 are expected to borrow is testament to the fact that the primary cause of state UI trust fund insolvency was due to factors outside the control of individual states or employers in a particular state.

This immediate relief should be the first step of a two step strategy to first address the immediate need for measures to encourage job creation, and secondly to develop state and federal plans for longer term solvency.

In evaluating longer term solvency measures we should address the appropriate state and federal roles in the employer financed Federal/State unemployment insurance system and how the unemployment insurance program may be most effective within the larger array of federal and state social safety programs providing assistance to unemployed workers.

Long Term Solvency

As of April 29, 2010, 35 states and jurisdictions had outstanding Title XII debts totaling more than \$41.1 billion. The federal unemployment account from which states borrow to pay unemployment compensation is itself in deficit and relying on transfers from the federal general revenue fund to cover loan obligations.

The federal extended unemployment compensation account from which regular federal extended benefits are funded is in deficit along with the federal unemployment account. Each additional dollar spent at this point through the federal unemployment account or extended unemployment compensation account is subject to interest to be paid to the general revenue fund and because the general revenue is operating in a deficit position, each additional dollar being spent for unemployment compensation adds to the federal deficit.

According to the US Department of Labor's projections for the President's FY 2011 budget, very large amounts of borrowing from the Federal Unemployment Account are projected over the next few years. The balance of outstanding loans is projected to increase from \$41.1 billion to a peak end-of-year balance of \$93 billion in FY 2013. A total of up to 40 states are projected to borrow.

Individual state unemployment benefit accounts are in even worse shape. Many states have unpaid balances in Title XII loans that are greater than one year of state unemployment benefit payments and state UI tax revenue has been overwhelmed with increases in benefit payments. For example, Indiana has a current unpaid Title XII balance of over \$1.8 billion with annual state UI tax revenue of only \$499 million and annual benefit payments of \$1.8 billion. California has a current unpaid Title XII balance of over \$8.8 billion with annual tax revenue of only \$4.7 billion and annual benefit payments of \$10.9 billion.

It is not possible for these and a number of other states to increase state unemployment taxes enough within the period before the next recession to reach current USDOL solvency suggestions without unprecedented tax increases or slashes to benefit payments. The imposition of interest on Title XII loans and increasing net FUTA taxes for employers in borrowing states will make it even more difficult to overcome these deficits.

Virtually no economists, state officials, legislators, or employers in 2007 anticipated the size and depth of the Great Recession of 2008 and 2009. Most states were prepared to meet the benefit payment requirements of a 2001 size recession but not one with historical proportions. Even states such as Hawaii, which enjoyed a relatively solvent state unemployment trust fund balance that met USDOL guidance in 2007 found itself faced with a projected deficit, a tremendous automatic state unemployment tax increase for 2010, and very little time to enact state legislation to adjust to the changing circumstances. Without emergency legislation in early 2010 Hawaii employers would have faced an increase in average per employee state unemployment taxes from \$90 per employee per year to \$1,070 per year. Even with emergency legislation the per employee tax increase on average is in the \$600 per employee range, and will continue to increase dramatically to cover the size of benefit payment obligations.

Many states found themselves in a sea of red ink with very little time to make adjustments in unemployment tax rates or benefit payout. In some states weekly benefit amounts had been indexed to increase while the state unemployment tax base remained static. Also, initiatives to drastically cut benefits or increase payroll taxes during a recession were viewed as counter-productive to assuring the economic security of unemployed workers or the economic recovery needed to produce additional jobs.

State UI tax increases have begun. In 2010, state unemployment tax wage bases increased in 24 states, and according to a survey conducted by the National Association of State Workforce Agencies (NASWA), contribution rate schedules are expected to increase in 28 states, and 10 states are already at their highest rate schedules. Employers will see a

further rise in rates due to the increase in unemployment experience in individual employer accounts.

The increase in state unemployment insurance taxes for 2011 is due in large part to benefit claims charges to employer accounts for the year ending June 30, 2010, one of the highest claims periods in history. The impact on state unemployment tax rates lags the increase in benefit payout by one to three years as the increase in benefit charges begins to become a factor in the calculation of experience rated state unemployment tax rates. In addition, because so many states are insolvent, many states have automatic solvency trigger taxes that will become effective in 2011 and 2012.

The additional imposition of increases in the FUTA tax through the reduction in the FUTA offset credit penalty will increase payroll tax burden and discourage new hiring. Employers in Michigan have already had the FUTA penalty imposed for 2009, and based on current and projected Title XII loan balances, Michigan, South Carolina and Indiana will be subject to penalties for 2010 and twenty five states will be subject to penalties for 2011. These FUTA penalties add to the already dramatic state unemployment tax increases in 2010 and expected for 2011 and 2012.

A coordinated effort on the part of the states and the federal government is essential to solve the deficit problem. Clearly, given the size of the state and federal debt and already skyrocketing state UI taxes, the solution should include relief from federal penalties to assure that the economic recovery continues, and longer term strategies to address the appropriate scope of the employer financed UI system and to manage the tremendous state and federal UI system debt.

PLANS TO ADDRESS FEDERAL AND STATE UNEMPLOYMENT TRUST SOLVENCY

Federal and state studies of UI system solvency are needed. Studies should include a review of the major revenue and cost drivers, including 1) state and federal unemployment tax bases, 2) tax rates, 3) adjustments in tax and benefit amounts, 4) benefit eligibility requirements and conditions of payment, 5) weekly benefit amounts and duration, 6) debt management, 7) extended benefit trigger provisions, 8) circumstances under which Federal loans may be available to states and terms of repayment, 9) clear delineation of the scope of the employer financed unemployment insurance system within the larger context of social safety net programs, and 10) proper administrative financing, including targeted administrative funding for integrity.

Improve Experience Rating

A critical element of the Federal/State unemployment compensation system is the requirement that employer contribution rates under state law must be based on factors related to unemployment. This requirement assures greater employer participation in determinations with respect to the allowance of unemployment compensation benefits and weekly determinations of eligibility because employers have an economic interest in

whether their accounts are charged and their contribution rates are increased. The requirement adds integrity to the system by increasing the likelihood that UI agencies will have the information needed to determine fraud and overpayments.

The experience rated system assists in avoiding erroneous payments and preserving unemployment trust fund dollars for those who properly qualify.

It also enables employers to project unemployment compensation costs, encourages proper management of human resources, and provides a fair basis upon which to distribute the cost of state unemployment compensation among the employers participating in the system.

In reviewing state unemployment tax rates, a comparison of state contribution rate schedules could be helpful in identifying best practices. The experience rate index (ERI) maintained by USDOL demonstrates that in some states many employers have contribution rates at the maximum rate, resulting in less incentive to control unemployment compensation costs. Some states have high minimum tax rates, resulting in greater contributions to be paid by employers that may never have laid-off an employee. Some states have a limited number of tax rate increments, reducing the incentive to manage costs.

The experience rated system works best when there is a direct relationship between unemployment claims experience and contribution rates. Artificial minimums or maximums may result in non-experienced based cost shifting. However, it should be recognized that each state has a different industrial mix, claims pattern and history that should be considered in any comparison.

There should also be an evaluation of the so called “non-charged” benefits that have increased in a number of states, undercutting the experience rated features of the program.

Long Term Solvency and Debt Management

The size of the state unemployment trust fund debt is so great in most states that a goal to meet solvency standards suggested by USDOL or the existing state law solvency standards within five years would require tax increases and/or benefit cuts which are simply too great, and would destroy the creation of jobs or eviscerate the primary safety net for the state workforce.

The review of possible solutions to the long term problem should include the write off of outstanding loans while addressing the need to reset the size of the program and the financing of it.

Avoid Job Killing Increases in Federal and State Unemployment Taxes

Employers decide to create jobs and maintain higher levels of employment based not only on the demand for goods and services but also on the costs associated with employees.

State unemployment taxes will be increasing dramatically in the next two years and stay at a much higher rate for a decade before solvency returns to state UI trust funds. Employers with relatively low state unemployment taxes will experience even greater percentage increases. As a point of comparison, for 1982, the state unemployment tax as a percent of total wages was 1.759%, nearly triple the state UI taxes as a percent of total wages of 0.61% as of the second quarter of 2009. Increases of this size will adversely impact job creation. A plan to address taxes and benefits while managing the outstanding debt is needed.

Keep the role of the UI program as it was established

As it was enacted and signed by President Roosevelt in 1935, the unemployment insurance program was smaller in scope than it is today. The program did not include a federal extended benefit program and there was no requirement that individuals working for non-profit agencies or state and local governments were to be covered for state unemployment compensation. Legislation enabling states to borrow from federal funds to pay unemployment benefits did not begin until the late 1950s and the Federal/State Extended Unemployment Compensation Act was not enacted until 1970.

At inception, unemployment insurance was a larger part of the national social safety net because the workforce relied primarily on wages and savings for economic security. The UI system was established as a temporary partial wage replacement program for workers who became unemployed through no fault of their own in connection with their work who were able to work, available for work and actively seeking work. That purpose and focus should be maintained.

A long list of social safety net programs and services has been established since unemployment insurance was enacted in 1935. The list includes TANF, TAA, WIA, SNAP, Medicaid, Medicare, heating assistance, subsidized housing, subsidized child care, subsidized health care, and earned income tax credits. Many of these programs include a cash assistance component.

Unemployment insurance plays a relatively minor role in the social safety net for individuals eligible for many of these programs. Economically disadvantaged individuals typically rely more on public assistance and social service programs for support than wages.

An individual who earns \$100 per week for 30 weeks a year would typically be eligible for assistance under many social service programs for the economically disadvantaged and would rely principally on support from those programs. Because UI is only a partial

wage replacement program for such an individual, he or she would be likely to receive only approximately \$50 per week in unemployment compensation for up to 26 weeks, significantly less than the support provided by other programs.

Unemployment Insurance is much more important in providing economic security for individuals who rely principally on their employment and wages for support. The UI program serves a very specific purpose that employers are willing to support with dedicated employer tax dollars.

In developing plans to assist unemployed workers in returning to work, the UI program should be used in conjunction with workforce programs dedicated to provide job search, reemployment and training services that may be funded from other sources but are aligned to provide economic security and effective workforce services to the benefit of the individual, employers, and economic development.

Reduce Unemployment Compensation Pay-Out

As the economy recovers, jobs become more widely available and the unemployment rate declines, there will be a reduction in total benefit pay out. At the same time increases in unemployment tax revenue will result from higher payrolls, experience rate tax increases and solvency taxes. Although the trend lines will improve, without carefully assessing the long term cost of benefits and taxes and making appropriate adjustments, history will repeat itself with benefit obligations in the next recession that outstrip our ability to pay.

The scope of the unemployment insurance system in a number of states has been expanded and benefit payout associated with these expansions has contributed to the insolvency of the state unemployment benefit accounts and ultimately the depletion of the Federal Unemployment Account.

Areas to review include monetary qualifying requirements, dependency allowances, weekly benefit amounts, waiting periods, work search and availability requirements, conditions of removal of disqualifications, weekly benefit offsets, overpayment collections, and fraud.

In some instances, expanded benefit provisions were enacted with a provision socializing the cost or relying on temporary funding. Unfortunately, although benefit costs may not be charged to a specific employer account, the increased cost to the state unemployment trust fund nonetheless must be paid for with taxes to be paid by all employers or cuts in other benefit provisions. Also, long term costs associated with expansions that were temporarily funded must be accounted for in determining long term solvency.

Improve Accuracy and Integrity

One of the most effective ways to address solvency is to encourage unemployed workers to take jobs that are available. A number of administrative and policy measures have been

shown to be effective in motivating unemployed workers to reduce their duration of unemployment compensation.

During the 2008-2009 recession it was understandably difficult for state UI administrative staff to focus on benefit payment control, re-employment services, and fraud and overpayment recovery when the priority has been to assure that the growing number of unemployed workers were able to complete their applications and file weekly claims forms to be paid quickly.

Paying attention to whether individuals are actively seeking work and making accurate benefit determinations sends the signal to unemployed workers that they are expected to take the initiative to actively seek work and be accountable.

One established method to improve integrity is the Eligibility Review Program (ERP), which ensures that benefits are being properly paid by continuously reviewing a claimant's ability to work and promoting an active search for work by assisting claimants in their job search plan. Although the ERP program has been demonstrated to be effective in reducing unemployment duration, it has been underfunded in recent years.

Historically, during times when significant numbers of claims are processed under strained conditions the number of claims paid erroneously and the incidence of fraud increases. Even in non-recession years, approximately 10% of unemployed claimants are erroneously paid benefits for a variety of reasons and in most cases the erroneous payments are overpayments. Fraudulently claimed overpayments typically range from 2% to 3% of payments, and also increases with the amount of payments being made. A UI program that pays out more than \$120 billion is likely to have overpayments of close to \$12 billion including up to \$3.6 billion in fraudulent overpayments. In light of this, targeted administrative funding is essential immediately. The longer the lack of dedicated funds for integrity functions, the more difficult it will be to assure active work search, avoid inaccurate payments, or effectively collect overpayments. Also, immediate attention and publicity of the fact that the agency is cracking down on fraud serves as a deterrent to fraud. Funding is needed to procure detection and collection systems and dedicate staffing to increase the capacity and the integrity of the system.

UWC supports the cross-matching of quarterly wage information, and new hire data bases with unemployment claims data to identify overpayments and fraud. Federal legislation requiring a monthly statement of charges to employer accounts would also be helpful in indentifying erroneously paid and charged benefits

It should be noted that the Congressional Budget Office and the Administration have recognized that dedicated integrity funding produces net revenue for the unemployment trust funds and the federal unified budget. The combination of compelling need and net benefit to the trust funds should prompt immediate action.

CONCLUSION/RECOMMENDATION

The status of the slowly recovering economy and the need for jobs dictates that we must first do no harm to discourage job creation and economic recovery. The federal penalties that would otherwise be imposed in the form of Title XII loan interest and the FUTA offset credit penalty should be waived for two years to avoid dampening the creation of jobs and the economic recovery.

Studies of the primary cost and revenue drivers of federal and state unemployment trust funds should be conducted with a view toward identifying solutions that recognize the need to avoid tax increases that would negatively impact job creation and to reduce long term duration of unemployment. The mission of the UI system to provide temporary partial wage replacement for unemployed workers who become unemployed through no fault of their own in connection with their work should be preserved.