PERFORMANCE AUDIT

SOLVENCY OF THE MISSOURI UNEMPLOYMENT COMPENSATION TRUST FUND

From The Office Of State Auditor
Claire McCaskill

Action is needed to ensure the long- term solvency of the Unemployment Compensation Trust Fund.

Report No. 2002-01
January 9, 2002
www.auditor.state.mo.us

Office of
Missouri State Auditor
Claire McCaskill

January 2002

YELLOW SHEET

State unemployment benefits fund will be insolvent in 2003, forcing state officials to borrow money and employers to bear the cost

Benefit payments from the state's Unemployment Compensation Trust Fund are expected to exceed revenues by $414.4 million in calendar years 2001 and 2002, leading to the fund's insolvency. If insolvency occurs, state officials will borrow money from the federal government to keep paying benefits, which will likely increase employer costs.

This audit reviewed the status of this trust fund to define the factors causing its current instability. Auditors found four main factors causing the insolvency: low unemployment tax rates, no requirement that each employer contribute to the fund, low taxable wage base, and increased benefit payments with no rise in revenue. The recommendations focus on the legislative changes needed to restore the fund's financial stability and long-term solvency.

Fund has faced insolvency twice before

Missouri's trust fund became insolvent during both the 1983 and 1992 recessions. In the 1992 insolvency, the state had to borrow $81.5 million from the federal government to cover unemployment benefits. Employers had to repay the loan plus $3.4 million in accrued interest. As a result, legislators changed state labor laws to keep the fund balance at an acceptable level. These legislative changes resulted in an eight-fold increase in the fund from $57 million in 1993 to $491 million in 1998. But the new laws also restrict the fund balance growth once it reaches $500 million, which did not allow continual fund growth during good economic times. (See page 2)

State's key indicator of fund solvency falls well below national average

To evaluate the fund's solvency, both state and federal officials use a figure, known as a "average high cost multiple," which represents the number of years a state's trust fund can pay benefits without additional revenue. In early 2001, Missouri's multiple decreased to .28, indicating the state could only pay benefits for 3.36 months before needing more revenue. The national average multiple is 1.12 and seven of the eight states bordering Missouri also have higher multiples. (See page 4)

Employer unemployment tax rates are too low

Missouri ranked 40th in the nation in the average unemployment tax rate levied on employers in 2000. State laws require employers pay a basic tax rate of 2.7 percent, not to exceed 6 percent. The minimum tax rate can further decrease if the employer has few unemployment claims during a year. In addition, the maximum tax rate does not always cover some employers' use of the fund. One employer now at the maximum 6 percent rate has paid $100 million to the fund since it first became an employer, but its former employees have filed $167 million in claims during the same time period. (See page 5)

Some employers do not contribute to fund

State law allows employers whose employees file very few unemployment claims to eventually pay no state unemployment taxes. In 2000, 23 percent of the employers did not pay unemployment taxes. If state officials required all employers to pay taxes at a minimum level, the fund would increase with little burden to the employer. For example, a .1 percent tax rate charged to the employers not paying unemployment taxes would generate an extra $1.9 million a year. (See page 7)

State's taxable wage base is lowest allowed

Missouri's $7,000 taxable wage base is the lowest federal law will allow. The taxable wage base is the portion of employee earnings on which an employer pays unemployment taxes. Missouri is one of 11 states with this minimum taxable wage base. Sixteen states have indexed their taxable wage base to average wages, which allows the base to increase as average wages increase. These 16 states have been more successful in maintaining adequate fund balances. (See page 7)

SOLVENCY OF THE MISSOURI UNEMPLOYMENT COMPENSATION TRUST FUND

TABLE OF CONTENTS

CLAIRE C. McCASKILL
Missouri State Auditor

Honorable Bob Holden, Governor
and
Members of the General Assembly
and
Catherine Leapheart, Director
Department of Labor and Industrial Relations

The State Auditor's Office audited whether state statutes ensure the solvency of the Unemployment Compensation Trust Fund (the fund). We concluded state statutes do not ensure the solvency of the fund and as a result, the fund is expected to be insolvent in 2003. The General Assembly should consider adjusting unemployment tax rates for liable employers and making other changes necessary to restore the fund to sound fiscal condition and ensure its future solvency.

The audit was conducted in accordance with applicable standards contained in *Government Auditing Standards*, issued by the Comptroller General of the United States, and included such tests of the procedures and records as were considered appropriate under the circumstances.

Claire McCaskill
State Auditor

November 16, 2001 (fieldwork completion date)

The following auditors contributed to this report:

Director of Audits:	William D. Miller, CIA
Assistant Director:	Kirk R. Boyer
Audit Manager:	Robert D. Spence, CGFM
In-Charge Auditor:	Robert E. Showers, CPA

224 State Capitol • Jefferson City, MO 65101
Truman State Office Building, Room 880 • Jefferson City, MO 65101 • (573) 751-4213 • FAX (573) 751-7984

RESULTS AND RECOMMENDATIONS

Action Is Needed to Ensure the Solvency of the Unemployment Compensation Trust Fund

Missouri's Unemployment Compensation Trust Fund (the fund), which is used to pay unemployment benefits, will become insolvent in 2003. This situation is occurring because benefit payments are expected to exceed fund revenues by a projected total of $414.4 million for calendar years 2001 and 2002. Restrictive state laws have contributed to this condition by (1) limiting the state's ability to increase employer unemployment tax rates, (2) allowing some liable employers to avoid paying into the system, (3) allowing a minimum wage base of $7,000, and (4) increasing benefits without increasing revenue. Once the fund becomes insolvent, the state will have to borrow funds from the federal government which will likely increase costs to employers. Changes are needed in state labor laws to restore financial stability to the fund and assure the long-term solvency of the fund.

History of the fund

The Missouri Department of Labor and Industrial Relations (the department) administers Missouri's Unemployment Compensation Trust Fund, which provides temporary financial assistance to eligible unemployed workers and serves as an economic stabilizer. To meet this need, states initially administered forward-funded systems in which unemployment funds grew in good economic times and fell during distressed economic times. However, many states, including Missouri, have adopted a "pay-as-you-go" system, which matches unemployment taxes (revenue) with benefits paid during the year and reduces the tax burden on employers.

The benefits paid to unemployed workers are funded almost exclusively through payroll taxes paid by Missouri employers. Per state statutes, Missouri employers presently pay unemployment taxes on a percentage (the contribution rate) of the first $7,000 earned (the taxable wage base) by each employee per year. States are required by the federal government to maintain a minimum taxable wage base of $7,000. An employer's contribution rate fluctuates annually based on its use of the unemployment system. The department monitors the fund balance, as well as all employer contribution rates and employee benefit claims. Department personnel also perform fund balance projections with the primary variable being the rate of unemployment.

Missouri's trust fund became insolvent during the 1983 and 1992 recessions. Due to the 1992 insolvency, legislators attempted to keep the fund stable by increasing the contribution rate adjustment thresholds to their current levels. In 1994, another change in state labor laws increased the employer tax rate. In addition, the taxable wage base was temporarily increased by statute to $8,500 for 1994, 1995, 1996 and 1998, and set at $8,000 for 1997. As a result of these changes, the fund balance increased eight-fold, from $57 million at the end of 1993 to $491 million at the end of 1998. However, the fund balance did not continue increasing in favorable economic times because the statute mandates reduction in the fund's growth when it reaches $500 million.

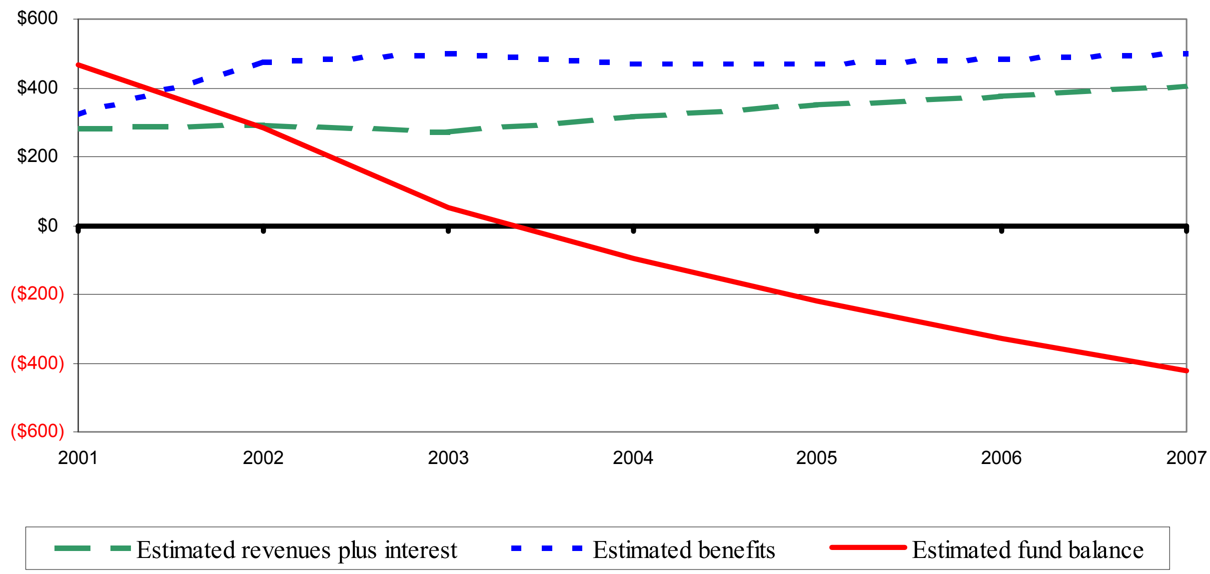
Audit procedures

We performed fieldwork at the department and reviewed fund balances from calendar year 1997 through August 2001. In addition to reviewing relevant state labor statutes, we reviewed department fund balance information and projections. We also used United States (U.S.) Department of Labor data to compare the fiscal condition of Missouri's fund with other states. We did not conduct a detailed review of claims paid by the department. *(See Appendix I, page 11, for additional information.)*

Fund insolvency expected by 2003

Department personnel predict that the fund will become insolvent in early calendar year 2003 because benefit payments are projected to exceed revenues. Figure 1 depicts the projected fund balance over the next 5 years, based on U.S. Department of Labor projected unemployment rates and no change in current state labor laws.

Figure 1: Projected Fund Balance and Unemployment Rates Based on Current Law
(Dollars in millions)



Source: October 2001 department projections

Department data indicates benefit payments exceeded fund revenues in calendar year 2000, creating a fund shortfall of $41.9 million, despite very good economic conditions. Using October 2001 department data, additional shortfalls of $183.3 million in 2001 and $231.1 million in 2002 are projected, partly due to an increase in projected unemployment during those periods. As depicted in Figure 1, department personnel expect this deficit trend to continue through 2006 unless changes are made to factors that affect fund revenues.

Business association representatives recognize need for change

Representatives of the Associated Industries of Missouri, Missouri Chamber of Commerce, and National Federation of Independent Business (industry representatives) expressed concern over the fiscal condition of the fund and acknowledged that corrective action is needed to ensure the long-term solvency of the fund. However, the industry representatives also expressed concern that department personnel may have contributed to the problem of insolvency by approving invalid unemployment claims related to discharge issues such as misconduct and excessive absenteeism.

We did not assess the validity of claims paid by department personnel. However, department officials estimate that about 20 percent of the total claims approved involved discharge issues for calendar year 2000. These cases totaled $58.8 million of the $355.1 million, or 17 percent, in total claims paid.

Key indicator shows Missouri's fund balance is not adequate

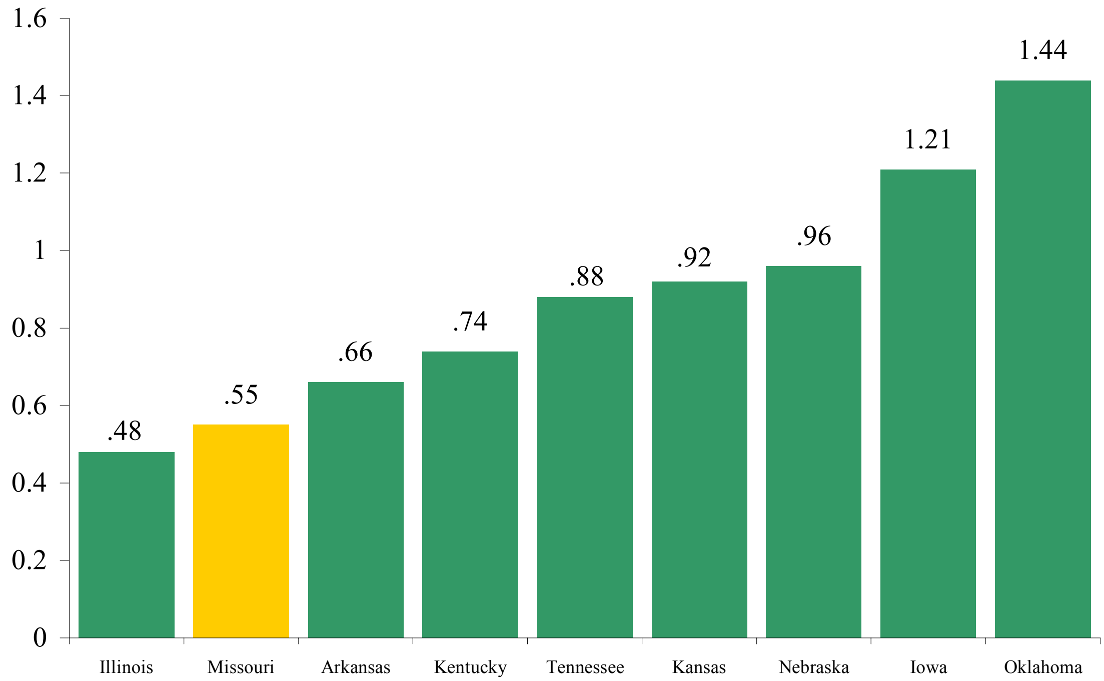
State and federal labor personnel use an "average high cost multiple" to help evaluate the solvency of the fund. This multiple represents the number of years a state's trust fund would be able to pay benefits with no additional revenue by assuming payouts equivalent to the average of its three historically highest cost years. Therefore, the multiple is an attempt to measure trust fund adequacy by comparing the fund balance to potential liabilities. Missouri's multiple of .55 is well below the national average multiple of 1.12 for the fourth quarter of calendar year 2000.[1] As of the first quarter of calendar year 2001, Missouri's multiple had decreased to .28, which indicates the fund would only be able to pay benefits for approximately 3.36 months,[2] assuming no revenues, according to department personnel.

Missouri's average high cost multiple is compared to those of eight bordering states in Figure 2 on page 5. Only five states nationwide, including one of Missouri's bordering states, had a lower multiple than Missouri. The U.S. Department of Labor recommends a multiple of 1.0, which would require a fund balance of approximately $1.3 billion, according to department personnel. *(See Appendix II, page 12 for information on other states.)*

---

[1] Based on U.S. Department of Labor data.
[2] This figure is calculated by multiplying 12 months by the average high cost multiple of .28.

Figure 2: Average High Cost Multiple Ratio For States Bordering Missouri Fourth Quarter 2000



Source: U.S. Department of Labor data

Several factors contribute to fund shortages

Several factors directly impact the fund balance: the contribution rate paid by employers, the taxable wage base, and benefits paid to unemployed individuals. These factors are controlled by state statutes and can only be changed by the state legislature. Each factor is discussed, as follows.

Employer unemployment tax rates are too low

State statutes allow tax rate reduction

State statutes set the rates used to determine amounts that employers pay into the fund and the basic tax rate liable employers must pay is 2.7 percent. However, state statutes allow the unemployment tax rate to decrease over time if the employer experiences few unemployment claims. For example, liable employers experienced an average rate of 1.2 percent for calendar year 2000 and contributed an average of approximately $97 per employee to the fund, according to department data. Missouri ranked 40th out of 50 states and the District of Columbia in average unemployment tax rate levied on employers for calendar year 2000, according to U.S. Department of Labor data. Department officials stated increasing the tax rates would generate additional revenue for the fund. According to department data, every 0.1

percent increase in the tax rate[3] would generate approximately $15.3 million in revenue each year.

Tax rate is capped too low

State statutes also set the maximum unemployment tax rate at 6 percent. Department officials believe the maximum rate is too low to cover some employers' use of the fund because claims have more than offset what those employers paid into the fund. For example, one employer currently at the maximum rate of 6 percent has paid a total of approximately $100 million into the fund since it first became an employer in Missouri. However, former employees of that employer have filed $167 million in claims against the system over that same time period. A small business industry representative expressed concern over such "deficit employers" and the financial drain caused when the value of claims filed consistently exceeds revenue some employers have paid into the fund. The representative stated that these employers are not paying enough into the program. Increasing the maximum tax rate paid by deficit employers would increase revenue, according to department data. For example, every 0.1 percent increase to the 6 percent rate would generate approximately $500,000 in additional revenue each year.

Fund balance thresholds are inadequate

State labor laws establishing fund balance thresholds are outdated. These thresholds trigger increases or decreases to the unemployment insurance tax rate paid by liable employers. The Missouri Revised Statutes[4] include provisions to decrease the employer contribution rates if, on October 1 of any given year, the average fund balance for the past calendar year exceeds $500 million. The statutes[5] include similar provisions to increase the employer contribution rate if the average fund balance falls below $400 million.

The state legislature established the current threshold levels when the fund became insolvent during the 1992 recession and these thresholds have not changed. The current threshold levels attempt to maintain a yearly fund balance of $400 to $500 million. However, according to a department official responsible for the oversight of the fund, a fund balance of $1.3 billion is necessary to assure fund solvency and to meet U.S. Department of Labor recommendations. Thus, increasing fund balance thresholds would allow the fund balance to accumulate during good economic times, according to the official.

Other states, according to U.S. Department of Labor personnel, have tied tax rate adjustments to factors other than the dollar balance of the fund. For example, a number of states have tied tax rate adjustments to the "average high cost multiple," which measures the fund's ability to pay potential liabilities. Using the average high cost multiple as a trigger to change the tax rate allows the fund balance to automatically adjust

[3] Based on the current taxable wage base of $7,000 and assumes that the 0.1 percent would be added to the rate paid by the employer. Excludes employers that have a zero rate and those having the maximum rate of 6 percent.
[4] Section 288.122, RSMo 2000.
[5] Section 288.121, RSMo 2000.

to fluctuations in the labor market and the economy, and eliminates the need to have dollar value thresholds periodically increased by the legislature.

Some employers do not contribute

Missouri law allows employers with good experience ratings to earn a zero contribution rate and pay no state unemployment taxes. For calendar year 2000, 23 percent of liable employers did not pay unemployment taxes to the state. Missouri law includes provisions to adjust an employer's contribution rate based on the employer's use of the unemployment insurance system. For example, if none of an employer's former employees file an unemployment claim during a year, that employer's "experience rating" improves and the business is assigned a reduced contribution rate for the next calendar year. Missouri is one of six states that allow employers to have a zero tax rate, according to U.S. Department of Labor personnel.

Department personnel stated the majority of employers earning a zero tax rate are small businesses with few employees. According to department data, employers currently at the zero tax rate pay approximately 11 percent of the state's taxable wages. If all employers were required to participate, at least at a minimal level, it would increase the fund and not impose an undue burden on employers, according to department personnel. For example, every 0.1 percent charged to an employer would generate an additional $7 per employee, per year, in revenue.[6] If a tax rate of 0.1 percent was charged to all current zero rate employers, it would generate approximately $1.9 million per year in additional revenue, according to data provided by department personnel.

Missouri's taxable wage base is minimum allowed

Federal laws do not allow a taxable wage base of less than $7,000, and Missouri is one of 11 states that currently maintains this minimum base. The taxable wage base is the portion of each employee's earnings on which an employer must pay unemployment taxes. An increase in the taxable wage base would generate additional fund revenue, according to department personnel. For example, department data shows every $1,000 increase in the wage base would generate approximately $35 million each year.[7]

State labor laws also include provisions to adjust taxable wages based on fund balance thresholds.[8] If the fund balance exceeds $450 million on September 30 of a given year, the taxable wage base must be *reduced* $500 for the next calendar year. If the fund balance is less than $300 million, the taxable wage base must be *increased* $500 for the next calendar year. Increasing those thresholds would trigger an increase or decrease to the taxable wage base at higher fund balances which help keep the fund solvent, according to department personnel.

Indexing the taxable wage base to average wages would allow the base to increase as average wages increase in the state and eliminate the need for periodic legislative

[6] Assumes a current wage base of $7,000.
[7] Assumes no change to current unemployment tax rates paid by employers.
[8] Section 288.036, RSMo 2000.

changes to the taxable wage base. U.S. Department of Labor personnel stated 16 states indexed the taxable wage base to average wages, for calendar year 2001, and those states have been more successful in maintaining adequate fund balances.

Benefit payments have increased without offsetting increases in revenue

Benefits paid to unemployed individuals have increased since 1997, but revenue has not. The benefit is the amount paid to unemployed individuals who have filed a valid claim. State labor laws include provisions that prorate the benefit based upon the level of regular wages each individual earned while employed. In Missouri, the maximum weekly benefit amount is currently $250 per week. The legislature incrementally increased the maximum weekly benefit from $180 in 1997 to $250 in 2001, increasing total fund outlays over that period. However, while fund outlays were increasing, the legislature did not change the statutes to increase fund revenues. The lack of additional revenue, combined with increased unemployment experienced in 2001, has resulted in fund outlays exceeding revenues. As shown in Figure 1, page 3, this trend is projected to continue through the year 2006 unless an adjustment is made to Missouri labor laws.

According to the Employment Policy Foundation, a nonprofit public policy research and educational foundation, many states' inadequate unemployment reserves are due to excessive duration of benefit payments and high weekly benefit amounts. However, neither of these factors apply to Missouri's trust fund difficulties. Missouri paid benefits for an average of 13.3 weeks during calendar year 2000, which is slightly below the national average of 13.4 weeks. Further, Missouri's average weekly benefit of $186 during calendar year 2000, ranked 44th of 50 states and the District of Columbia.

An insolvent fund will increase costs to businesses

Insolvency will force state to borrow funds

When the fund becomes insolvent, the state will be forced to borrow funds from the U.S. Department of Labor in order to continue to pay unemployment benefits. State law prohibits the state from using other state funds or borrowing from any source other than the federal government for the purposes of paying unemployment benefits.[9] Interest is due on any federal borrowings if the balance cannot be paid off by the following September 30. According to a department official responsible for oversight of the fund, any additional costs associated with repaying such interest are passed on to employers, which could take place during a recession when employers could least afford it. For example, during the 1992 fund insolvency, the state was forced to borrow approximately $81.5 million from the federal government in order to continue to pay unemployment benefits. Employers were required to fund the repayment of the loan amount in addition to approximately $3.4 million in accrued interest. Based on current projections, industry representatives acknowledged that Missouri business owners will have to bear the burden of increased contribution rates to pay for another federal bailout of the fund.

According to United States Code Title 26(c) Section 3302, the state legislature must take action to resolve the insolvency of the fund within 2 years of becoming insolvent or the U.S.

[9] Section 288.330, RSMo 2000.

Department of Labor would incrementally reduce the federal unemployment tax rate credit[10] (worth approximately $900 million) provided to liable employers until cancellation.

Conclusions

Based on current projections, Missouri's Unemployment Compensation Trust Fund will become insolvent during 2003. While Missouri’s pay-as-you-go approach has minimized the tax burden on employers during good economic times, this approach has not sustained the fund. Current state statutes have limited contributions by liable employers and have not allowed the flexibility to generate additional revenue. Once insolvency occurs, Missouri employers will not only bear the cost to borrow any federal funds, but will also be assessed higher unemployment taxes in order to reestablish the fund balance. These additional costs could be assessed during an economic downturn, when employers can least afford them. Corrective action by the state legislature is needed to ensure the long-term solvency of the fund.

Recommendations

We recommend the General Assembly consider (1) increasing tax rates charged to all employers, including those currently at the maximum unemployment tax rate, (2) tying tax rate adjustments to the average high cost multiple, (3) requiring all liable employers to contribute to the trust fund, and (4) increasing the taxable wage base and indexing it to average wages.

Department of Labor and Industrial Relations’ response

The department agreed with the recommendations and responded as follows.

The Department of Labor and Industrial Relations has reviewed the draft report of the audit of the Solvency of the Missouri Unemployment Compensation Trust Fund. We appreciate the thoroughness of the report and concur with the conclusion that the trust fund will become insolvent during 2003. The Department has been concerned about trust fund solvency for several years but has not had the support of the business community in seeking solutions to avoid insolvency.

The Department concurs in your recommendation that the General Assembly consider legislation to increase the tax rates charged to all employers and to require that all liable employers contribute to the fund. The recommendations for legislation that ties the tax rate adjustment to the average high cost multiple and increasing the taxable wage base and indexing it to the average annual wage are both possibilities to reduce the future need to constantly adjust trust fund financing. However, these are not the only possibilities. The Department would support legislation that includes the recommendations you proposed as well as other alternatives that avoid insolvency. The Department has met with business and labor leaders to discuss the lack of solvency of the fund.

---

[10] Employers are eligible for a reduction of the federal unemployment tax rate because Missouri has enacted unemployment compensation statutes.

The Department is immediately available to work with any legislator to draft legislation that would overcome the insolvency problems. The Department is available to provide factual information to any party seeking to draft legislation. The Department will evaluate any proposed legislation and report on the projected impact on the fund. Implementation of this plan would be complete when corrective legislation is adopted.

APPENDIX I

OBJECTIVE, SCOPE AND METHODOLOGY

Objective

The primary objective was to determine whether state statutes ensure the solvency of the Unemployment Compensation Trust Fund (the fund).

Scope and Methodology

Auditors conducted an audit at the Missouri Department of Labor and Industrial Relations – Division of Employment Security.

To accomplish the audit objective, auditors did the following:

- Focused audit efforts on fund balance information for calendar year 1997 through 2002.
- Reviewed fund trend information from 1990 through 2002.
- Reviewed relevant statutes.
- Interviewed Department of Labor and Industrial Relations personnel responsible for managing and monitoring the fund.
- Interviewed U.S. Department of Labor personnel regarding the validity of the model used by the department for fund projections.
- Interviewed representatives of several employer interest groups to obtain opinions as to the solvency of the fund.
- Reviewed projections of fund solvency and projections of potential changes necessary to ensure fund solvency.
- Reviewed the projection model in detail in order to ensure the validity of these projections.
- Obtained data regarding unemployment trust funds of other states from the U.S. Department of Labor for comparative and evaluative purposes.

To obtain the views of industry representatives, auditors met with representatives from the Associated Industries of Missouri, Missouri Chamber of Commerce, and National Federation of Independent Businesses.

Auditors did not review the validity of unemployment claims paid by department personnel.

NATIONAL DATA ON KEY UNEMPLOYMENT FUND INDICATOR

Table II.1 shows there are only five states with lower average multiples than Missouri.

Table II.1: Distribution of Average Multiples

Location	Average High Cost Multiple
Texas	.26
North Dakota	.28
New York	.30
Illinois	.48
West Virginia	.51
Missouri	.55
Minnesota	.58
Ohio	.62
Alabama	.64
Arkansas	.66
Pennsylvania	.66
Michigan	.72
Kentucky	.74
California	.76
South Dakota	.82
Rhode Island	.87
Tennessee	.88
North Carolina	.89
Indiana	.92
Kansas	.92
Maryland	.92
Connecticut	.94
Nebraska	.96
Washington	.97
Massachusetts	.98
Alaska	1.02
Washington, D. C.	1.03
Colorado	1.04
Nevada	1.05
Wisconsin	1.05
New Jersey	1.11
Iowa	1.21
South Carolina	1.25
Virginia	1.30
Louisiana	1.33
Maine	1.38
Florida	1.39
Oklahoma	1.44
Montana	1.45
Oregon	1.45
Indiana	1.53
Hawaii	1.54
Utah	1.57
Wyoming	1.59
Arizona	1.63
Georgia	1.73
Mississippi	1.92
New Hampshire	1.95
Delaware	1.99
Vermont	2.48
New Mexico	2.76
Average	**1.12**

Source: U.S. Department of Labor data