



SUMMARY

A Management Review of the S.C. Employment Security Commission



HOW THE UNEMPLOYMENT INSURANCE TRUST FUND BECAME INSOLVENT

INTRODUCTION

Members of the General Assembly requested the Legislative Audit Council to conduct an audit of the S.C. Employment Security Commission. Our objectives were to:

- Provide a detailed accounting of the revenues and expenditures from the Unemployment Insurance Trust Fund since 2000.
- Determine the adequacy of the process for notifying state officials of the financial status of the Unemployment Insurance Trust Fund.
- Assess alternatives for maintaining the fund's solvency.
- Examine the unemployment eligibility benefit process for efficiency and compliance with law and policy.
- Evaluate the effectiveness of the agency's programs for assisting claimants in finding work.

In 1936, the General Assembly created the South Carolina unemployment compensation fund, known as the Unemployment Insurance (UI) Trust Fund. The fund is designed to pay unemployment benefits to eligible unemployed workers. In addition, the agency maintains a database (JobLink) of unemployed claimants and other persons looking for jobs, and assists businesses in filling job openings with applicants registered in JobLink.

INADEQUATE RESERVES

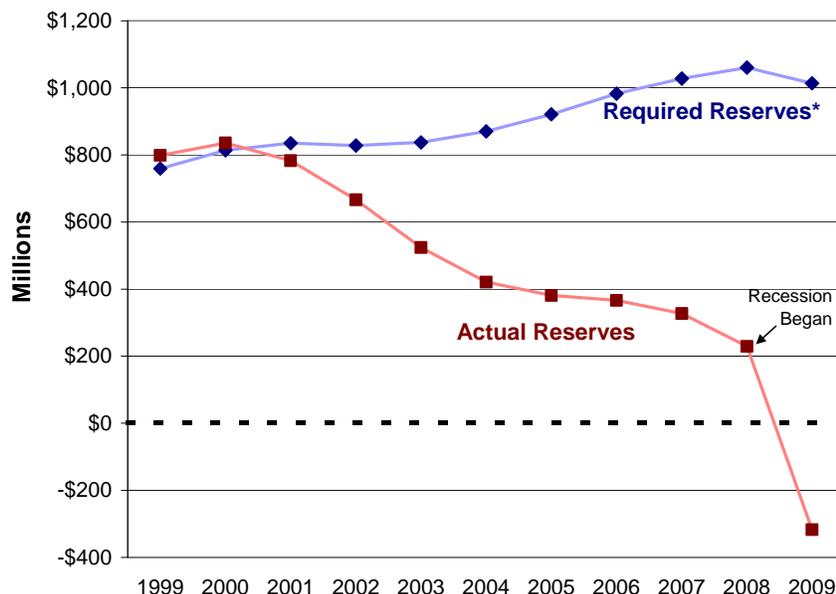
In 2000, the Unemployment Insurance (UI) Trust Fund had a balance of more than \$800 million, the minimum amount determined to be needed to pay claims during a recession. After the events of 9/11, the state's unemployment rate began rising and the agency's reserves began declining. As a result, when the recession began in 2008, the agency's reserves were well below the amount needed to pay benefits and maintain the fund's solvency. We found that:

- While agency management knew as early as 2001 that fund reserves were inadequate, management did not aggressively pursue changes to benefits, or the tax structure, in order to prevent the insolvency of the trust fund. When the 2008 recession began, the trust fund had reserves totaling \$229 million, \$831 million less than the recommended minimum amount.

As of December 2009, 24 states had UI Trust Funds that were insolvent.

- ESC's annual assessment reports to the General Assembly did not provide adequate information about the declining trust fund balance. Nor did ESC make recommendations to prevent the trust fund's decline as required by §41-29-280 and §41-29-290 of the S.C. Code of Laws.

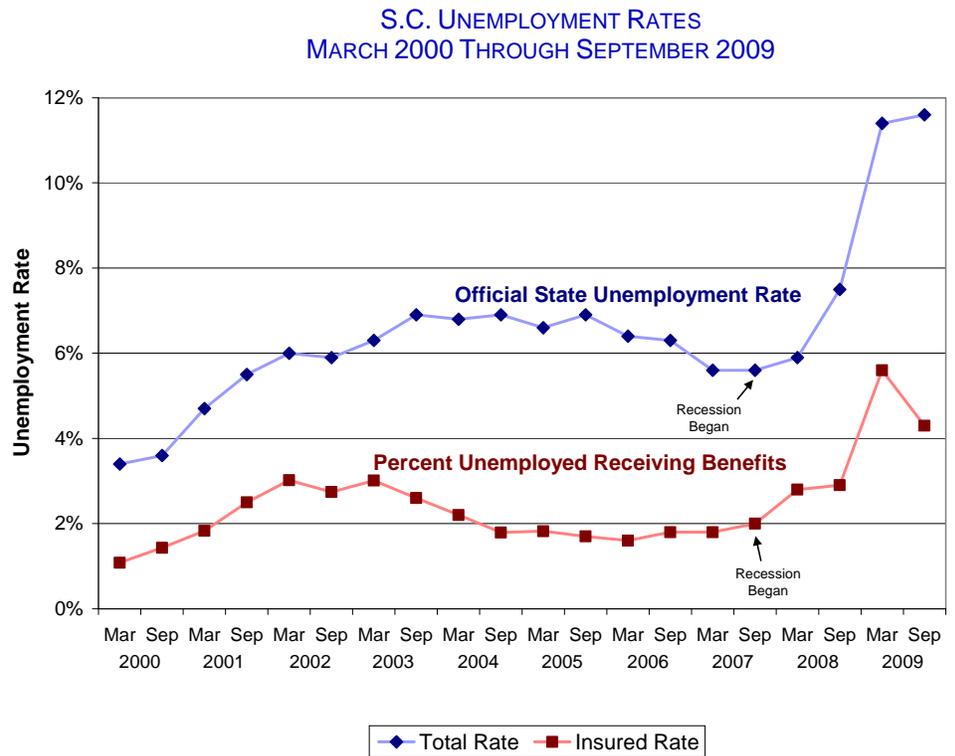
COMPARISON OF TRUST FUND RESERVE REQUIREMENTS TO THE ACTUAL BALANCE OF THE UI TRUST FUND (1999-2009)



◆ Required Reserve Amount ■ Trust Fund Balance

*Minimum reserve needed is 2% of total wages.

- ESC did not follow United States Department of Labor (DOL) guidance regarding minimum reserves. Under DOL guidelines, South Carolina would have needed a reserve of more than \$1.6 billion. Had DOL’s guidance been followed, the UI trust fund would still have a significant surplus.
- A higher level of unemployment caused an increase in benefit payouts and resulted in a severe and steady decline in the trust fund balance.
- Agency management has stated that one cause of the trust fund insolvency was the 1999 tax changes. Management indicated that this change caused lower tax revenues. However, the tax changes resulted in \$52 million more being collected than would have been collected under the prior system. More revenue was collected because the tax changes were accompanied by a tax surcharge which was triggered by a declining balance in the UI trust fund.
- Trust fund interest earned on the funds on deposit also declined from approximately \$50 million in 2000 to \$2.3 million by the end of 2008. Interest earned helped to offset tax increases and was forgone when the trust fund balance was allowed to decline.



EXPENSES NOT CONTAINED

The maximum weekly benefit amount that claimants may collect in South Carolina is currently \$351 (including \$25 per week funded by the federal government). Claimants can currently qualify for up to 99 weeks of unemployment benefits. Each state sets its benefit level and has discretion regarding who can obtain benefits. We found that:

- South Carolina, unlike most states, allows employees to collect unemployment benefits even if they lose their jobs due to their own misconduct. From July 1, 2006, to June 30, 2009, ESC paid approximately \$171 million (10% of total benefits) to employees who were terminated for cause.

Examples of employees who lost their jobs for “cause” but still collected unemployment include:

- An employee made unauthorized charges on his company’s credit card, which included motel rooms, hardware, and internet dating charges. He was terminated by the company, but ESC still allowed him to collect \$3,586 in unemployment benefits.
- An employee was discharged for absenteeism due to his incarceration. The commission allowed him to collect \$5,868 in unemployment benefits.
- An employee made a job-related threat and alluded to a weapon in his car. Police found a loaded firearm in the employee’s car. He was terminated for cause, but still collected \$2,440 in unemployment benefits.

- South Carolina is one of only seven states that pays unemployment benefits to employees who have a job, but are temporarily unemployed due to plant maintenance, reduced work schedule, or other reasons. These are known as “job-attached” claims. Between FY 06-07 and FY 08-09, ESC paid over \$100 million in unemployment benefits to workers who had a job but were experiencing a temporary break in service.

- In February 2008, the agency stopped referring for criminal prosecution claimants who had fraudulently obtained unemployment benefits. In FY 08-09, the agency identified more than \$7.3 million that was lost due to claimant fraud. In all seven fraud cases we examined, the claimants knowingly withheld information to obtain or increase their unemployment benefits; each case had overpayments totaling over \$10,000.

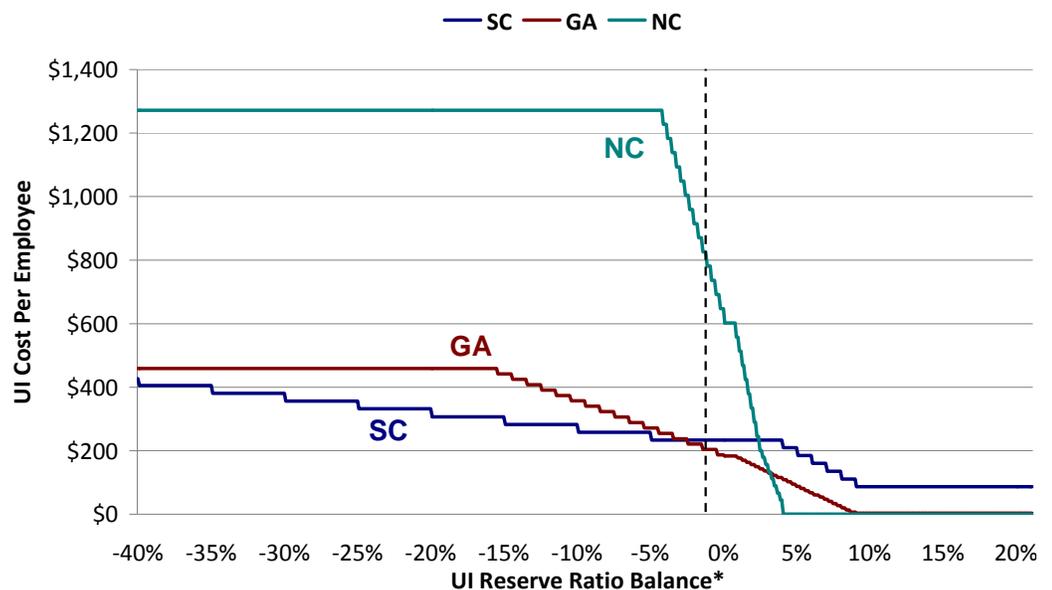
UNEMPLOYMENT TAX RATE

Every business pays into its own “unemployment insurance account.” An employer pays taxes on only the first \$7,000 of employee wages. The amount of tax paid varies according to an employer’s reserve ratio, which is based on how often the business’s employees become unemployed. Employers who rarely or never lay off employees generally have a positive reserve ratio and a lower tax rate. Businesses that lay off employees can have a negative reserve ratio, resulting in a higher tax rate. We found that:

- The current taxable wage base of \$7,000 is not effectively related either to benefit eligibility or to individual employer reserves needed to respond to unemployment. Since the tax is only collected on the first \$7,000 of wages, the amount of the tax is the same for an employee whether he earns \$7,000 or \$21,000. However, the amount of benefits received by the employees varies because the benefits are based on the employees’ salaries. Thus, the employee making \$21,000 a year who loses his job and collects unemployment receives significantly more in benefits than an employee paid \$7,000 a year.
- The current tax structure provides that some employers with a positive reserve ratio balance in their UI accounts pay the same tax rate as other employers who have a negative reserve balance.
- Employers with negative reserve ratios over 40% do not pay an additional tax yet still have claims paid on behalf of their employees. Employers who have reached the maximum tax rate (6.10%) because they have a negative reserve of more than 40% are incurring claims without contributing additional tax to the fund. Instead, additional claims are paid out of the pooled money in the trust fund. In effect, the negative reserve employers are subsidized by contributions paid by employers with a positive balance.
- Employers with “job-attached” claims account for a disproportionate share of employers who have negative balances in their accounts. We found that approximately 25% of all employers who file “job-attached” claims have a negative reserve ratio versus 11% of all employers. Also, about 11.5% of all employers with a negative reserve balance 40% or greater file “job-attached” claims.

- Compared to neighboring states, South Carolina taxes are lower for businesses which “overuse” unemployment benefits and higher for employers who rarely or never use the system. The chart shows that businesses in North Carolina and Georgia with good employment histories (i.e. large positive account balances) pay no unemployment insurance taxes, whereas businesses that use the system extensively (large negative balances) pay a higher amount than South Carolina businesses.

MAXIMUM AND MINIMUM TAX PER EMPLOYEE



*An employer's reserve ratio is calculated by taking the total amount of taxes paid by the employer, less benefits paid, divided by the business's annual taxable wages.

- Some employers with high negative reserve balances may never regain a positive reserve balance. In a random selection of 4 employers, of those with a balance of 80% negative or more, we found 2 of the 4 had reserve ratios greater than 150% negative and 1 of those had a reserve balance of negative \$1.8 million. This means the company's workers had collected \$1.8 million more in benefits than the company paid in taxes. We estimate that it would take the employer 28 years to pay back in taxes the amount of unemployment benefits that had been collected by the company's employees.

CONSEQUENCES OF THE TRUST FUND'S INSOLVENCY

Every state is required to pay unemployment benefits even if the state's UI account is insolvent. If a state's trust fund becomes insolvent, state taxpayers, private employers, and those receiving unemployment benefits can all be affected. South Carolina has had to borrow from the federal government in order to continue paying unemployment benefits. By the end of 2009, the state had borrowed almost \$700 million. If the federal loans are not repaid in a timely manner, businesses face higher federal taxes as a result of the loss of a federal tax credit. Also, there are interest charges on the federal loans that cannot be paid, directly or indirectly, from UI taxes. The state's first interest payment will be due in September 2011 and is estimated to be \$52 million.

As a result of the insolvency, employers face federal and state tax increases, claimants face potential cuts in benefits, and the state faces paying interest charges. This can result in lower economic growth, less job creation, and a reduction in consumer demand.

EMPLOYMENT AND TRAINING SERVICES

In addition to paying unemployment benefits and collecting taxes, ESC assists claimants in finding work. We found that ESC could improve its efforts to return claimants to work.

- While ESC has a procedure for matching clients with job referrals, it does not have a written policy regarding what criteria should be used in this screening process. In addition, unemployed claimants are not given priority, as required by agency policy.
- Claimants who are referred for job interviews, but do not show up, are still allowed to collect unemployment benefits.
- ESC's goal for staff-assisted job placements of claimants is 20% and 15% for veterans. Thus, approximately 65% of ESC's job placement goal is for non-claimants or individuals who already have jobs.
- Less than half of all job vacancies in the state are listed with ESC. ESC employs job developers whose duties, in part, are to convince businesses to list job vacancies with ESC. However, these staff do not have goals or other measures for management to determine their effectiveness. ESC currently estimates that only 40% of all vacancies are listed with the agency.
- The agency is required to profile clients who are "likely to exhaust their unemployment benefits." These claimants are referred for assessment and specialized services. However, the agency has not measured whether these claimants actually obtain employment.

MANAGEMENT AND ADMINISTRATIVE PROCESSES

ESC is recruiting a new executive director. A goal for new management should be to conduct a thorough review of the agency's mission, how business practices support the agency's mission, and how to ensure public confidence in the agency's ability to serve employees and businesses. Our review found a number of processes that should be closely examined by the new director to ensure the UI trust fund is properly maintained, accounting controls are instituted, the internal audit function is strengthened, and that management processes are effective. We found that:

- The agency's internal auditor could be more effective. The auditor has not had a formal role in overseeing the UI trust fund.
- Multiple external financial audits have documented material weaknesses in accounting practices. However, the agency has not corrected these deficiencies.
- ESC did not properly investigate allegations of mismanagement at one of its workforce centers. The agency's internal auditor was not made aware of these allegations and was not provided a copy of a report prepared by agency human resources staff which contained these allegations. We found no evidence that ESC attempted to verify the allegations of fraud. In addition, central office staff alleged to have been involved in instructing local office staff to violate policy was sent to monitor the local office.
- We found no evidence that the agency's executive management notified ESC commissioners or the General Assembly that state law needed to be changed in order for extended benefits to be provided to certain claimants. As a result, the General Assembly had to return in October 2009 to address the issue.
- ESC does not currently have a written agency-wide information technology plan. The current planning process is on a project-by-project basis without an overall plan to address information technology issues.
- The ESC director, unlike previous directors at ESC, has commuted to work in a state car without reimbursing the agency.

THE EMPLOYMENT SECURITY COMMISSION ADMINISTERS A STATE INSURANCE PROGRAM. IF THE ESC WERE A PRIVATE INSURANCE COMPANY, THE AGENCY COULD HAVE EITHER LOST ITS LICENSE TO OPERATE IN SOUTH CAROLINA, AS EARLY AS 2001, FOR NOT MAINTAINING AN ADEQUATE RESERVE FUND BALANCE OR BEEN REQUIRED TO INCREASE ITS RESERVES TO ACCEPTABLE LEVELS.

CONCLUSION AND MAJOR RECOMMENDATIONS

South Carolina's commission form of management is unique. With the exception of Georgia, where the labor commissioner is an elected position, the Governors in other southeastern states have greater authority over their state's workforce agency than in South Carolina. In order to regain solvency, implement greater accountability, and improve existing management practices, the General Assembly or agency management should implement the following major recommendations:

Options to reform agency governance should include:

- Making the commission a cabinet agency with an executive director appointed by the Governor with the advice and consent of the Senate. The director would be responsible for appointing an appeals board which would replace the three-member commission and only hear appeals of agency decisions.
- Allowing the Governor to appoint the executive director with the commission being appointed by the General Assembly. The commission would be limited to hearing appeals of UI decisions.
- Allowing the Governor to appoint commission members with the advice and consent of the Senate. The commission would be responsible for appointing an executive director.

Other major recommendations include:

- The Employment Security Commission should ensure that its annual assessment reports include, at a minimum, a five-year trend chart that shows the trust fund's balance at the end of each year. This chart should compare the ending balance with the minimum reserves needed to withstand both an "average recession" and a severe recession.
- The Employment Security Commission should request the assistance of the actuarial experts from the U.S. Department of Labor to assist with providing recommended tax changes to the General Assembly. If this assistance is not readily available, ESC should contract with a professional actuarial firm that specializes in unemployment tax rate analysis to provide recommendations to enact a more equitable tax rate.
- The General Assembly should amend §41-35-120 of the S.C. Code of Laws to provide that an employee terminated for cause is not eligible for unemployment benefits.
- The Employment Security Commission should revise its job placement goals to place a greater emphasis on obtaining employment for claimants.
- The Employment Security Commission should refer all cases of significant claimant and employer fraud to appropriate authorities to determine if criminal charges are warranted.

AUDITS BY THE LEGISLATIVE
AUDIT COUNCIL CONFORM TO
GENERALLY ACCEPTED
GOVERNMENT AUDITING
STANDARDS AS SET FORTH BY
THE COMPTROLLER GENERAL OF
THE UNITED STATES.

FOR MORE
INFORMATION

Our full report,
including comments from
relevant agencies,
is published on the Internet.
Copies can also be obtained by
contacting our office.

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SOUTH CAROLINA GENERAL ASSEMBLY
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Independence, Reliability, Integrity

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