

State of South Carolina Office of the Governor

NIKKI R. HALEY
GOVERNOR

1205 PENDLETON STREET
COLUMBIA 29201

October 11, 2011

The Honorable Hilda L. Solis
Secretary of Labor
200 Constitution Avenue, NW
Washington, D.C. 20210

Via e-mail to: Gilbert.Gay@dol.gov
Milhollin.Dianna@dol.gov

**Re: STATE OF SOUTH CAROLINA APPLICATION FOR 2011 FUTA CREDIT
REDUCTION AVOIDANCE**

Dear Madam Secretary,

Please consider and approve the following final application and request from the State of South Carolina for avoidance of the federal tax credit reduction for calendar year 2011 per 20 C.F.R. Part 606—Tax Credits Under the Federal Unemployment Tax Act; Advances Under Title XII of the Social Security Act. In particular, we have added additional information on improved solvency located on pages 5-8 of the application.

My very best,

A handwritten signature in dark ink, appearing to read "Nikki R. Haley", is written over a circular embossed seal. The signature is fluid and cursive.

Nikki R. Haley

NRH/kh

Attachments

FUTA Avoidance Application

In order to qualify for the avoidance of a 0.6% reduction in the credit South Carolina employers would receive for calendar year 2011 federal unemployment taxes the State must:

1. Make a repayment of all advances received under title XII of the Social Security Act in the one-year period ending November 9, 2011 in addition to a payment of the potential additional taxes that would be payable if paragraph (2) of section 3302(c) of FUTA were applied for 2011,
2. Have sufficient funds in the State unemployment fund sufficient to pay all benefits when due and payable during the three-month period beginning November 1, 2011 without receiving any advance under title XII of the Social Security Act, and
3. Have a net increase in the solvency of the State unemployment compensation system for calendar year 2011 that equals or exceeds the potential additional taxes for calendar year 2011 as estimated under §606.23 C.F.R. 20.

Repayment Projections: Current Advances

Between November 10, 2010 and November 9, 2011 the state of South Carolina is projected to have received advances of \$115,174,766.56. The monthly advances for the time period are detailed in Table 1.

Table 1¹: Monthly Federal Title XII Advances, November 2010-November 2011

Month	Federal Advance
November 2010	\$0
December 2010	\$0
January 2011	\$39,615,422.28
February 2011	\$14,166,628.61
March 2011	\$37,276,410.79
April 2011	\$24,116,304.88
May 2011	\$0
June 2011	\$0
July 2011	\$0
August 2011	\$0
September 2011	-\$115,174,766.56 (loan repayment—Sept 15 th)
<i>October 2011</i>	<i>\$0</i>
<i>November 2011</i>	<i>\$-68,200,000 (FUTA avoidance—Nov 1st)</i>

Projections in italics

The state made its repayment of these advances September 15, 2011. A second voluntary payment is planned for early November 2011.

¹ Source: Treasury Direct Unemployment Trust Fund reports.

Repayment Projections: Potential FUTA Payable

The US Department of Labor provided the state of South Carolina with a preliminary estimate of the additional taxes that would be payable by the State's employers if the 0.6% credit reduction were to be in effect for calendar year 2011. That initial estimate was \$68.2 million based on projections of 2011 taxable wages.

The state plans to make a voluntary payment of \$68.2 million on or about November 1, 2011.

Revenue, Benefits, and Balance Estimates

The state made significant changes to its tax systems (as outlined in the next section), so comparison of estimates to prior years is not recommended. The new tax system was designed to more closely match revenue needs for the calendar year by making estimates of benefit payments, loan repayments, and interest payments for calendar year 2011.

Table 2 shows the estimated end-of-fund balance, benefit outlays, revenue receipts, and scheduled "other payments" from June 2011 through January 2012. Actual values are displayed through September. The data for the same period in the prior year is also shown in Table 3. However, these benefit outlays were made during the peak of the recession when South Carolina's unemployment rate ranged between 11% and over 12% in a given month. Also, the revenue receipts are likely to be less than half of those expected under the new tax system.

A more thorough explanation of the assumptions underlying the values in Table 2 can be found below.

The projections show that the state should have sufficient funding to remain solvent through January 31, 2012 in accordance with 606.23(a)(2). The projected end of month balance with no additional federal advances is about \$40 million. Additional advances may be required during the period February 2012 through April 2012 until the first quarter 2012 contributions are received.

Table 2: End-of Month Balance, Benefit Outlays, Revenue Receipts^{2,3}, June 2011-January 2012 (millions)

Date	Benefit Outlays	Revenue Receipts	Other Outlays/Adjust.	End of Month Balance
Jun 2011	\$29.5	\$1.6	\$0	\$245.8
Jul 2011	\$34.3	\$57.7	-\$51.0	\$218.2
Aug 2011	\$33.5	\$45.3	\$33.5	\$263.5
Sep 2011	\$29.9	\$1.2	-\$115.2 (1-yr loan) \$11.0 (other)	\$130.6
Oct 2011	<i>\$44.4</i>	<i>\$149.6⁴</i>	<i>\$0</i>	<i>\$235.8</i>
Nov 2011	<i>\$32.0</i>	<i>\$6.1</i>	<i>-\$68.2 (FUTA avoid)</i>	<i>\$141.7</i>
Dec 2011	<i>\$50.4</i>	<i>\$1.0</i>	<i>\$0</i>	<i>\$92.3</i>
Jan 2012	<i>\$41.9</i>	<i>\$0.3</i>	<i>\$0</i>	<i>\$50.7</i>

Projections in Italics

Table 3⁵: End-of Month Balance, Benefit Outlays, Revenue Receipts, June 2010-January 2011 (millions)

Date	Benefit Outlays	Revenue Receipts	Other Outlays/Adjust.	End of Month Balance
Jun 2010	\$52.5	\$6.69	\$0	\$60.0
Jul 2010	\$43.4	\$10.8	-\$2.1	\$25.3
Aug 2010	\$44.3	\$4.0 (+\$97.5 UI modern. funds)	+\$36.2	\$118.7
Sep 2010	\$41.5	\$1.9	-\$2.5	\$81.6
Oct 2010	\$36.6	\$6.5	-\$5.3	\$46.2
Nov 2010	\$40.2	\$26.9	\$0.4	\$32.5
Dec 2010	\$42.5	\$14.9	\$2.1	\$7.0
Jan 2011	\$34.1	\$36.5 (includes advances)	-\$1.2	\$8.2

Benefits

The estimates for benefit payments are derived from the historical relationship between the US total unemployment rate (US_TUR), the state total unemployment rate (SC_TUR), and the state benefit outlays (BEN). Ordinary Least Square regression was used on data between 1980 and 2010 to estimate the benefit payments for 2011 and 2012. The US_TUR was obtained from the Congressional Budget Office's fall Economic Outlook. The 2012 estimates for benefits will be updated in November 2011 using the latest available report.

² Finance Department figures

³ *Treasury Direct Unemployment Trust Fund reports*

⁴ Additional \$146 million received from state appropriations.

⁵ Source *Treasury Direct Unemployment Trust Fund reports*

The estimated benefit payment for 2011 used to set the tax rates was \$500 million. To date (10-1-11) only \$359.2 million has been paid in regular UI benefits. The average level of weekly benefit payments for July, August, and September has been \$8.4 million. A conservative estimate for the remainder of the year was made at \$8.3 million for all weeks in October and November 2011. Based on higher seasonal claims experienced during December, an estimate of \$9.0 million per week was used.

New legislation was passed June 14, 2011 that lowered the maximum benefit amount to the lesser of one-third of base period wages or 20 times the individual's weekly benefit amount. This lowers the average maximum state weeks to 20 from 26. This is expected to reduce benefit payments in the long run, but the estimates in Table 2 continue to project the higher benefit amount to be conservative until we have actual data to verify expected cost savings.

Revenue

Taxes for 2011 were set to raise approximately \$660 million based on estimates of taxable wages in 2010 plus 2 percent nominal wage growth.

Legislation passed in 2010 raised the state's taxable wages from \$7,000 to \$10,000. The system was also changed from a reserve ratio experience rating system to a benefit ratio system. The fixed tax rate tables based on the balance of the state's trust fund was eliminated in favor of an "array" system with 20 tax tiers. Employers with higher benefit ratios are assigned to higher tax tiers and higher tax tiers have higher tax rates. Approximately 5% of taxable wages are assigned to each tax tier such that employers with the lowest benefit ratios fall into the first tax tier and employers with the highest benefit ratios fall into the 20th tier. Tax rates were adjusted slightly due to the fact that about 10% of taxable wages fell into tier 1 in 2011. Over 45,000 employers had a benefit ratio of 0 and were thus all assigned to the same tax tier.

Based on historical data, most contributions will be paid in the first and second quarter of the year due to the fairly low taxable wage base. The revenue projections in Table 2 use the historical percentage of contributions received in each month multiplied by the projected total revenue for the calendar year.

Other Outlays

The state made an initial voluntary repayment of the outstanding advances taken between November 10, 2010 and November 9, 2011 on September 15, 2011. Contributions from the first and second quarter were sufficient to make a voluntary repayment in the sum of \$115,174,766.56.

The state has received an initial estimate from the Department of Labor that a voluntary payment of \$68.2 million is necessary to meet the requirements. For 2011 all state employers would be subject to a 0.6% credit reduction on their federal unemployment taxes. The revenue estimated to be raised from this additional \$42 per worker is \$68.2 million. The state plans to make this voluntary repayment on or around November 1, 2011 after third quarter contributions have been received.

Improved Solvency Measures

During the 2010 legislative session the South Carolina General Assembly made significant changes to the unemployment insurance tax structure. Under previous law the state had a fixed table of tax schedules that changed depending on the level of the trust fund. The state had been at the highest rate table since the early 2000s yet only raised revenue maxing out at around \$277 million per year. This level of collection resulted in a perpetual under funding of the trust fund between 1999 and 2010 as benefit payment levels

ranged between \$188 million and \$910 million per year. The trust fund fell from a high of around \$800 million in 2000 to insolvency by December 2008.

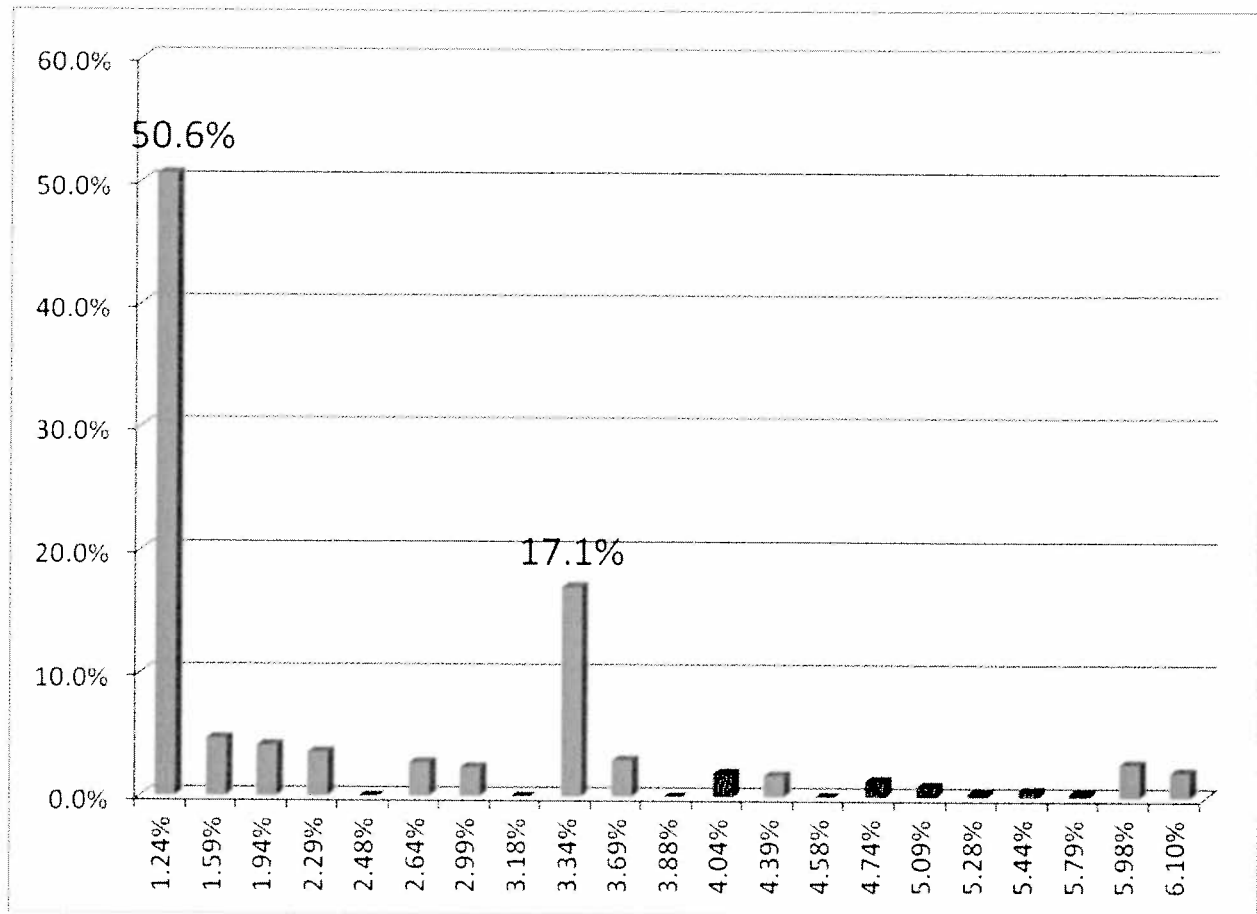
The major reforms to the tax structure are embodied in Act 234 (2010), which made significant changes to Chapter 31 of Title 41. There were also some changes to benefit payments in Act 234 (2010) and H3762, which took effect June 14, 2011. The combination of the tax increases and benefit reductions from these two pieces of legislation should be sufficient to meet the requirement of §606.24(3).

Experience Rating

Section 41-31-5 moved the state from the reserve ratio system of experience rating employers to a benefit ratio experience rating system. This system should be an improvement over the reserve ratio system that had very wide intervals before tax rates changed.

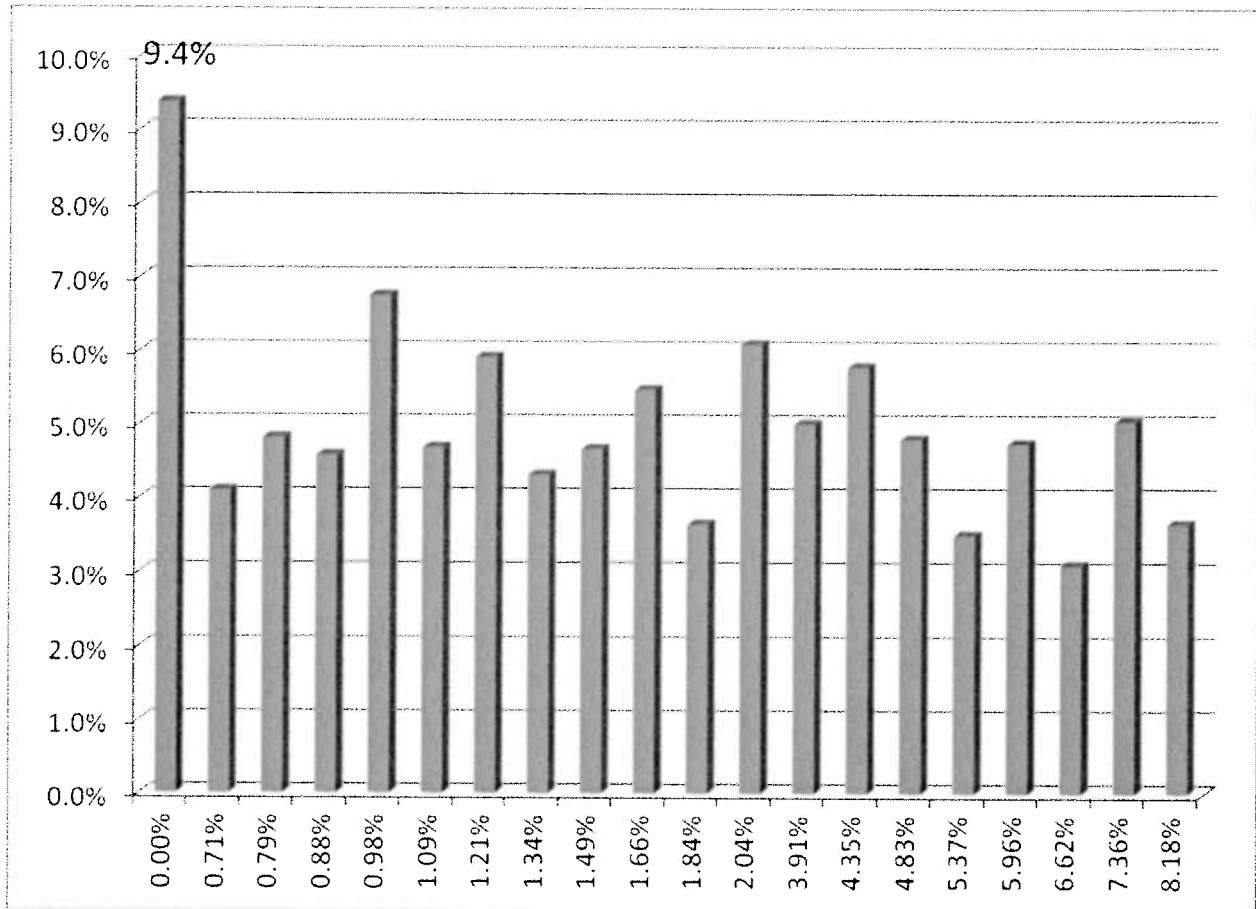
In Figure 1 the percentage of taxable wages taxed at each of the tax rates in effect for 2010 are shown. As can be seen, a majority of taxable wages in the state (50.6%) were being taxed at the lowest tax rate of 1.24% while less than 5% were charged the maximum tax rate of 6.1%. This clumping of employers under the old experience rating system, along with a very low taxable wage base, contributed to the system's perpetual underfunding.

Figure 1: Percent Taxable Wages by Tax Rate (2010)



The new benefit ratio system that went into effect in 2011 better spreads taxable wages equally between tax rates. In theory there should be approximately 5% of taxable wages in each tax class. Since there were almost 10% of employer with no benefit charges in the last seven years, there is a slight bunching of employers in the lowest tax class; however, in general the new system is much more uniform in its distribution of taxable wages across tax rates, as seen in Figure 2.

Figure 2: Percent Taxable Wages by Tax Rate (2011)



The benefit ratio system only considers recent employer experience while the previous reserve ratio system considered the employer's lifetime contributions and benefit charges. The state feels that the benefit ratio system adopted in Act 234 will more quickly and accurately reflect an employer's true experience with the system and place them in the appropriate and corresponding tax rate.

Section 41-31-5. As used in this chapter:

(1) 'Benefit ratio' means:

(a) for the period of January 1, 2011, through December 31, 2013, the number calculated by dividing the average of all benefits charged to an employer during the forty calendar quarters immediately preceding the calculation date by the employer's average taxable payroll during the same period. If fewer than forty but more than four calendar quarters of data are available, the data from those available calendar quarters shall be used in the calculation. The benefit ratio must be calculated annually on July first to the sixth decimal place;

(b) from January 1, 2014, the number calculated by dividing the average of all benefits charged to an employer during the twelve calendar quarters immediately preceding the calculation date by the employer's average taxable payroll during the same period. If fewer than twelve but more than four calendar quarters of data are available, the data from those available calendar quarters shall be used in the calculation. The benefit ratio must be calculated annually on July first to the sixth decimal place.

(2) *'Department' means the Department of Employment and Workforce.*

(3) *'Statewide average required rate' means the amount of income projected to be needed by the unemployment insurance trust fund for the upcoming calendar year divided by the estimated taxable wages over the same period rounded to the sixth decimal place.*

(4) *'Statewide average interest surcharge' means the amount of income projected to be needed to pay interest on outstanding federal advances during the upcoming calendar year divided by the estimated taxable wages for the upcoming calendar year.*

Flexible Tax Rate Determination

Sections 41-31-45, 41-31-50, and 41-31-55 (see Appendix A), in conjunction with 41-31-5, established a flexible tax system by allowing the Department to adjust tax rates annually based on a projection of benefits to be paid in the upcoming calendar year, an estimate of the amount of loan repayments necessary to avoid FUTA credit reductions, and a projection of income required to pay interest using a special interest surcharge. By matching the tax rates to projected revenue needs the Department feels it will be better able to maintain the trust fund at a healthy level by making the required adjustments without waiting for legislative approval.

For 2011 the estimated revenue projections were \$500 million for benefits, \$146 million for loan payments, and \$34 million for interest. Thus, tax rates for 2011 were set to raise approximately \$660 million based on estimates of 2010 taxable wages. Compared to approximately \$270 million in contributions in calendar year 2010, this change in the tax system represents an increase in solvency of nearly \$400 million. Even if actual collections fall short of the \$660 million mark, the change to the tax system should allow the state to meet the requirement to improve solvency as defined to avoid the FUTA credit reduction.

Taxable Wage Base

Prior to the 2010 reforms South Carolina maintained the minimum allowable taxable wage base of \$7,000. The last time the state changed the taxable wage base was in 1983 when the federal wage base was increased to \$7,000. The reforms also allow the taxable wage base to increase an additional two times to \$12,000 in 2012 and \$14,000 in 2015. 41-2-380

SECTION 41-27-380. Wages.

B) For the purpose of Chapter 31, Article 1 of this title, "wages" does not include that part of remuneration which, after remuneration equal to ten thousand dollars for the period of January 1, 2011, through December 31, 2011, twelve thousand dollars for the period of January 1, 2012, through December 31, 2014, and fourteen thousand dollars from January 1, 2015, has been paid in a calendar year to an individual by an employer or his predecessor or with respect to employment during any calendar year, is paid to the individual by the employer during the calendar year unless that part of the remuneration is subject to a tax under a federal law imposing a tax against which credit may be taken for contributions required to be paid into a state unemployment fund. For the purposes of this subsection, employment includes service constituting employment under any unemployment compensation law of another state.

Reduction in Benefits

Additional overhauls to the laws governing unemployment in South Carolina were passed in June 2011. H3762 provided for a reduction in the maximum benefit amount for an unemployment claimant from twenty-six (26) times his weekly benefit amount to twenty (20) times his weekly benefit amount.

Section 41-35-50. The maximum potential benefits of any insured worker in a benefit year are the lesser of:

- (1) twenty times his weekly benefit amount;*
- (2) one-third of his wages for insured work paid during his base period.*

If the resulting amount is not a multiple of one dollar, the amount must be reduced to the next lower multiple of one dollar, except that no insured worker may receive benefits in a benefit year unless, subsequent to the beginning of the next preceding benefit year during which he received benefits, he performed 'insured work' as defined in Section 41-27-300 and earned wages in the employ of a single employer in an amount equal to not less than eight times the weekly benefit amount established for the individual in the preceding benefit year."

Based on estimates of weeks paid in 2008 and 2009, this change is expected to save approximately 8% in benefit charges per year. For 2011 this would equate to approximately \$40 million annually ($0.08 \times 500,000,000$) or \$20 million for half a year. The full impact of the benefit reduction will not be felt until 2012.

Act 234 (2010) established that any individual who was terminated due to gross misconduct, as defined by 41-35-120 (see appendix B), would be ineligible for benefits beginning with the effective date of their claim and continuing until the individual had gone back to work, earned at least eight times their weekly benefit amount, and been separated again through no fault of their own.

These new gross misconduct provisions were applied to 2,904 individuals between April 1, 2010 and May 15, 2011. The agency also increased the number of average weeks of disqualification for individuals found to be terminated for cause not rising to the level of gross misconduct. Between April 1, 2010 and May 15, 2011 approximately 546,000 weeks of disqualification were imposed on approximately 47,000 claimants for an average disqualification of 11.6 weeks. In the same period the previous year the totals were 502,000 for 50,000 claimants or about 10.0 weeks. This increase in disqualification by 1.6 weeks for 47,000 claimants at an average weekly benefit amount of \$239 is estimated to have saved the trust fund approximately \$17.77 million. Including the savings from those fired for gross misconduct, the yearly savings from this legislative and departmental change is estimated to be about \$22.6 million.

SECTION 41-31-45. Debt status estimates; promulgation of regulations.

(A) For the purposes of this section:

(1) "Average high cost multiple" means the number of years the department could pay unemployment compensation, based upon the statewide reserve ratio, if the department paid the compensation at a rate equivalent to the average benefit cost rate in the three calendar years during the previous twenty calendar years, or the last three recessions, in which the benefit cost rates were the highest.

(2) "Benefit cost rate" means the rate determined by dividing the unemployment compensation benefits paid during a calendar year by the total covered wages in the State during that year. The calculation of the benefit cost rate may not include the wages and unemployment compensation paid by employers covered under Section 3309 of the Internal Revenue Code of 1986.

(3) "Income needed to pay benefits" means the estimate of benefits payable in a given calendar year less the estimate of interest to be earned by the unemployment insurance trust fund for that calendar year.

(4) "Statewide reserve ratio" means the ratio determined by dividing the balance in the trust fund reserve as of June thirtieth by the total covered wages for the previous twelve months in the State as of June thirtieth. The calculation of the statewide reserve ratio may not include the wages and unemployment compensation paid by employers covered under Section 3309 of the Internal Revenue Code of 1986.

(5) "Fund adequacy target" means an average high-cost multiple of one.

(6) "Trust fund reserve" excludes distributions from the federal government pursuant to 42 U.S.C. 1103, commonly referred to as the Reed Act.

(B) For each calendar year during which the state Unemployment Insurance Trust Fund is in debt status, the department must estimate the amount of income necessary to pay benefits for that year, the amount of income necessary to avoid automatic FUTA credit reductions, and an amount of income necessary to repay all outstanding federal loans within five years. Additional estimates of interest costs shall be determined concurrently.

(1) Estimates of the revenue needed to pay benefits will be based on Congressional Budget Office projections for the subsequent calendar year's total unemployment rate. This total unemployment rate will be adjusted for South Carolina based on the historic relationship between the unemployment rate in South Carolina and the national unemployment rate calculated from 1980 to present.

(2) The historic relationship, calculated from 1980 to present, between the total unemployment rate and the insured unemployment rate in South Carolina will be used to adjust the projected total unemployment rate to the rate of insured unemployment.

(3) Estimates of forecasted benefits will be based upon the prior three year average of the annual number of weeks compensated multiplied by an estimate of the average weekly benefit for the next year.

(4) Estimates of amounts to pay to avoid FUTA credit reductions and amount of repayments on the loan will be projected through consultation with officials at the US Department of Labor.

(C) After the fund returns to solvency, the department must promulgate regulations concerning the income needed to pay benefits in each year and return the trust fund to an adequate level as defined in subsection (A)(5).

SECTION 41-31-50. Determination of base rates.

Each employer eligible for a rate computation shall have his base rate determined in the following manner:

(1)(a)(i) Annually the department must calculate a contribution rate for each employer qualified for an experience rating. The contribution rate must correspond to rate calculated for the employer's benefit ratio class.

(ii) To determine an employer's benefit ratio rank, the department must list all employers by increasing benefit ratios, from the lowest benefit ratio to the highest benefit ratio. The list must be divided into classes ranked one through twenty. Each class must contain approximately five percent of the total taxable wages, excluding reimbursable employment wage, paid in covered employment during the four completed calendar quarters immediately preceding the computation date. Each employer must be placed in the class that corresponds with the employer's benefit ratio.

(iii) If an employer's taxable wages qualify the employer for two separate classes, the employer shall be afforded the class assigned the lower contribution rate. Employers with identical benefit ratios shall be assigned to the same class.

(b) The income needed to pay benefits for the calendar year plus any applicable income needed to reach the solvency target must be divided by the estimated taxable wages for the calendar year. The result rounded to the next higher one-hundredth of one percent is the average required rate needed to pay benefits and achieve solvency targets.

(c) The rate for class twenty will be set such that the entire schedule raises the income required to pay benefits for the year, as well as the income necessary to move the trust fund toward the solvency target, subject to the structure provided in this chapter. However, the rate for class twenty must be at least five and four-tenths percent.

(2)(a) If the calculated rate necessary for benefit rate class twenty exceeds five and four-tenths percent, then the rate for each preceding benefit rate class shall be equal to ninety percent of the rate calculated for the succeeding class, except that rate class twelve shall be set at one-fourth the rate calculated for class twenty, provided that the rate for class one shall be zero.

(b)(i) If the computed rate necessary for class twenty is less than five and four-tenths percent, then the rate for class twenty shall be set at five and four-tenths percent.

(ii) The rate for rate class twelve shall be calculated by multiplying the average tax rate computed in subsection (1)(b) by twenty, subtracting five and four-tenths percent, and dividing by nineteen.

(iii) The contribution rate for rate classes eleven through one shall be equal to ninety percent of the rate for the succeeding class, provided that the rate for class one shall be zero.

(iv) The contribution rate for class thirteen shall be equal to one hundred twenty percent of the rate calculated for rate class twelve.

(v) The contribution rate for rate class nineteen shall be set at an amount that allows for average contributions, beginning with class eighteen and ending with class fourteen, that are equal to ninety percent of the preceding class.

SECTION 41-31-55. Additional surcharges when fund insolvent; rates.

(A) In any calendar year in which the state Unemployment Insurance Trust Fund is insolvent, the State

shall impose additional surcharges on all employers to pay interest on the outstanding debt. The estimated amount of interest to be paid in the upcoming year will be divided by the estimated taxable payroll for the calendar year. The result rounded to the next higher one hundredth of one percent is the statewide average surcharge.

(B) The rate for class twenty will be set so that the entire schedule raises the income required to pay interest surcharges for the year, subject to the structure defined in subsection (A). The rate for each preceding benefit rate class shall be equal to ninety percent of the rate calculated for the succeeding class, except that the rate class twelve shall be set at one fourth the rate calculated for rate class twenty.

APPENDIX B: Act 234 (2010) Gross Misconduct

Section 41-35-120. An insured worker is ineligible for benefits for:

(4) Discharge for gross misconduct, and is ineligible for benefits beginning with the effective date of the request and continuing until he has secured employment and shows to the satisfaction of the department that he has performed services in employment as defined by Chapters 27 through 41 of this title and earned wages for those services equal to at least eight times the weekly benefit amount of his claim if he is discharged due to:

(i) wilful or reckless employee damage to employer property that results in damage of more than fifty dollars;

(ii) employee consumption of alcohol or being under the influence of alcohol on employer property in violation of a written company policy restricting or prohibiting consumption of alcohol;

(iii) employee theft of items valued at more than fifty dollars;

(iv) failure to comply with applicable state or federal drug and alcohol testing and use regulations including, but not limited to, 49 C.F.R. part 40 and part 382 of the federal motor carrier safety regulations, while on the job or on duty, and regulations applicable for employees performing transportation and other safety sensitive job functions as defined by the federal government;

(v) employee committing criminal assault or battery of another employee or a customer;

(vi) employee committing criminal abuse of patient or child in his professional care;

(vii) employee insubordination, which is defined as willful failure to comply with a lawful, reasonable order of a supervisor directly related to the employee's employment as described in an applicable written job description; or

(viii) employee wilful neglect of duty directly related to the employee's employment as described in an applicable written job description.