LEGISLATIVE REPORT

Federal Funding Shortfall

JANUARY 2025

Employment Security Department
WASHINGTON STATE

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Executive Summary

The 2023-25 Enacted Operating Budget[1] contained a General Fund-State (GF-S) appropriation for the Employment Security Department (Employment Security) to backfill the agency's shortfall in federal funding.

This is the second of two reports[2], which detail the use of these funds and provide recommendations for long-term solutions to address the impact of federal funding reductions on administration of the unemployment insurance (UI) program.

Highlights include:

- Federal funding never fully supports Washington's UI program, even as costs continue to increase.
- Employment Security has adapted to the post-pandemic environment:
  - The organization has restructured to reflect a growing agency and new ways of conducting business.
  - Post-pandemic consumer demands and operational needs differ as the agency seeks to achieve quality service-delivery goals.
- The fraud landscape has changed dramatically from the pre-pandemic era.
- Employment Security proposes an increase in authority to utilize additional state funding to maintain UI program operations and meet customer demand.

Background

Budget proviso

The 2023 Enacted Operating Budget provided $10 million of the General Fund-State (GF-S) appropriation for fiscal year (FY) 2024 and $11,227,000 of the GF-S appropriation for FY 2025

[1] Engrossed Substitute Senate Bill 5187 (2023)

[2] ESSB 5187(225)(25)(b) directs Employment Security to submit the initial report by November 1, 2023, and the subsequent report by November 1, 2024.

solely to address a projected shortfall of federal revenue that supports the administration of the unemployment insurance (UI) program.

The FY 2023-25[3] Enacted Supplemental Operating Budget provided additional funding for FY 2025 to continue addressing the federal revenue shortfall ($9,963,000 of the Administrative Contingency Account-State appropriation and $4,271,000 of the Employment Service Administrative Account-State appropriation).

The proviso directs Employment Security to submit two reports to the governor and appropriate committees of the Legislature in November 2023 and November 2024 outlining how this funding was utilized and recommendations for long-term solutions to address future decreases in federal funding.

Federal funding history

Washington's UI program is primarily funded by a U.S. Department of Labor (USDOL) UI Administration grant. Federal funding is two-pronged:

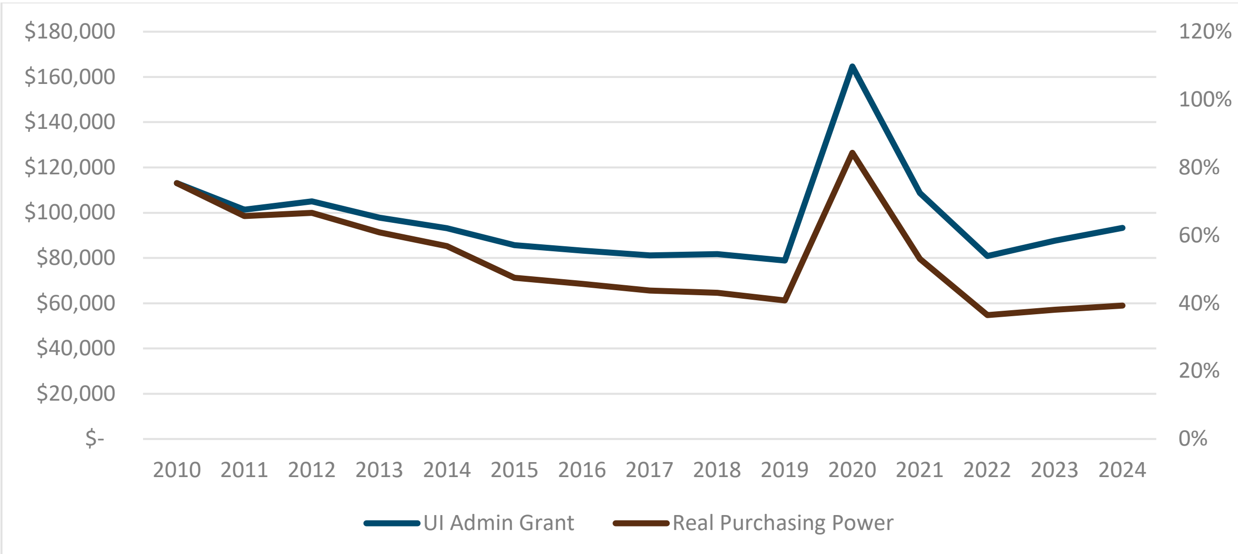
1. Base funding that is awarded to states and distributed at the beginning of each federal fiscal year (FFY), and
2. Above-base funding awarded on a quarterly basis for caseloads above the base level.

Current federal funding is inadequate to support increased costs of UI operations. The federal funding model further fails to address states' needs to modernize technology systems and manage an increasingly complex post-pandemic fraud landscape.

USDOL administrative grant funding from 2010 to 2024 appears flat, as shown in Figure 1. When the funds received over the same period are adjusted by the annual consumer price index (CPI) for each year, the funding level is losing ground, by about 20 percent.

[3] Engrossed Senate Substitute Bill 5950 (2024)

FIGURE 1. USDOL Federal Funding FFY 2010-2024, compared to purchasing power, rounded to thousands



USDOL's Resource Justification Model (RJM) is a data collection system used by state agencies to collect UI administrative expenditures from the most recently completed federal fiscal year to operate their UI programs. RJM data is integrated in the calculations of the amount of federal funds allocated to each state. This complex formula, owned and managed by USDOL, solely determines the UI base administrative funding allocated to the states.

The model does not adequately account for the actual costs to maintain a UI program that meets adequate levels of performance or modern norms of customer service. The factors that determine the total expected cost for UI administration, such as salaries and productivity measures, have not been updated since the 1990s. Prior to the pandemic, federal funding met 82% of the costs to manage the UI program. Post-pandemic, federal funding is meeting on average 72% of costs.

Inadequate federal funding makes it more challenging to maintain USDOL standards and customer expectations. In fact, federal base funding has not significantly increased since 2009. Nationally, the USDOL allocation for all state agencies was $2.3B in FFY2009. In FFY2025, the total award is $2.5B, as shown in Figure 2.

FIGURE 2. USDOL national base allocation, rounded to millions

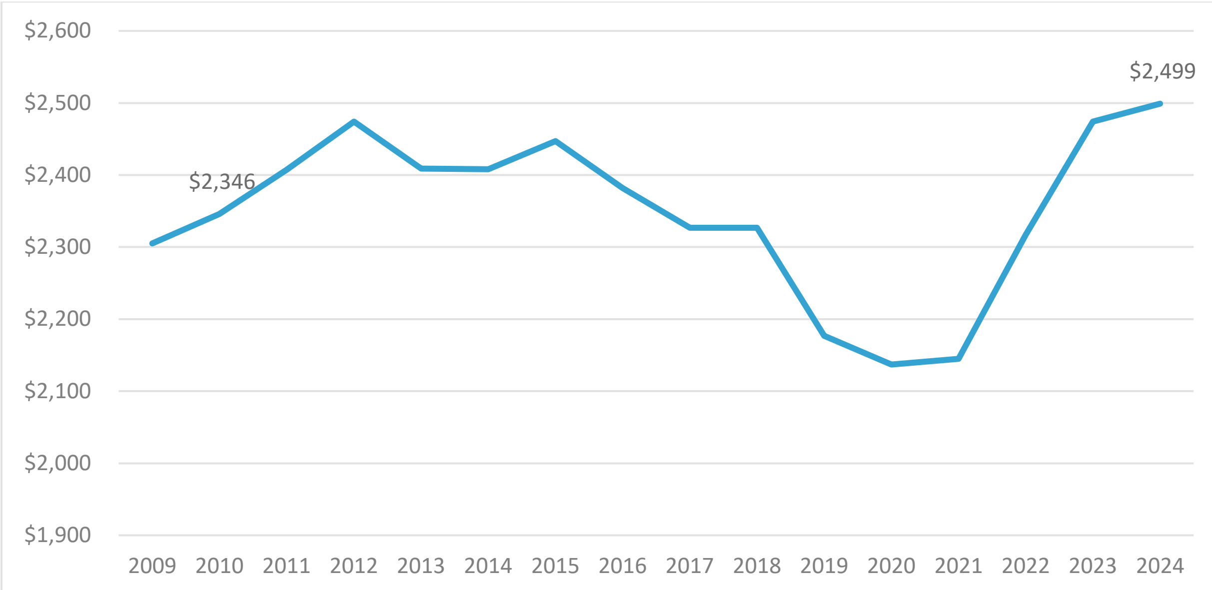
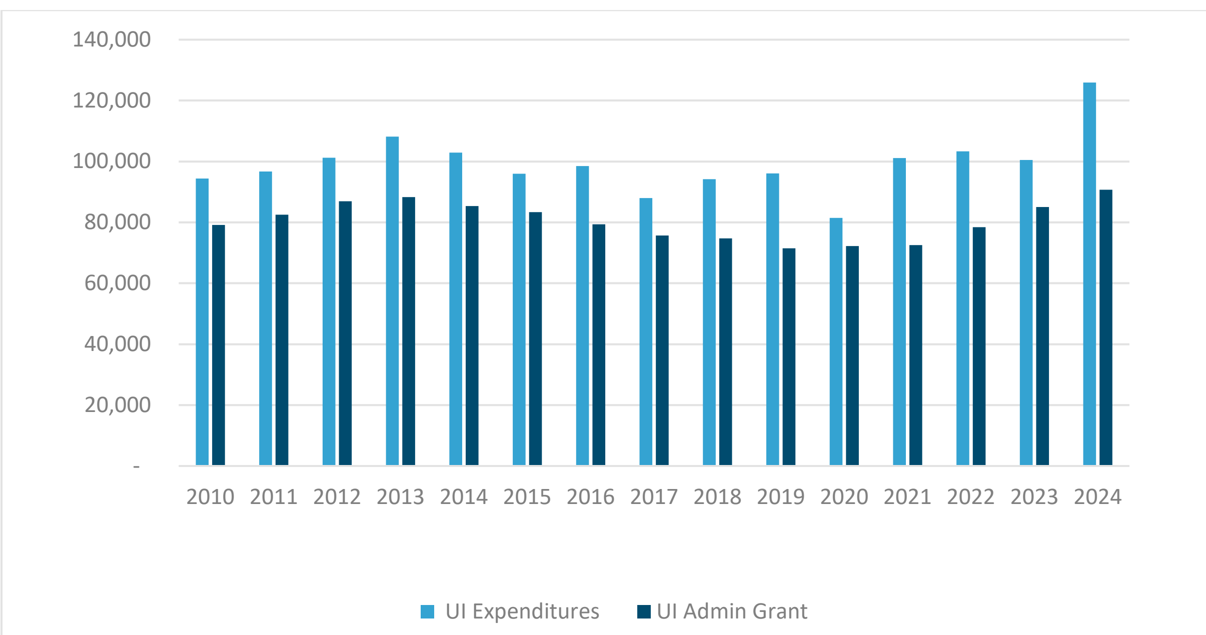


Figure 3 provides a 15-year historical look at Employment Security's RJM requests, and the amount of base funding received. Federal funds awarded to Employment Security have not covered the total expenditure incurred to operate the UI program. That gap has been growing over the years as depicted below.

FIGURE 3. Federal grant v. request/need, non-adjusted for CPI, rounded to the thousands



State accounts

Employment Security has never been fully funded by the federal UI Administration grant. Prior to the pandemic, federal funding met 82% of the costs to manage the UI program. Post-pandemic, federal funding is meeting on average only 72% of costs. To address the remaining costs of administering the UI program (along with other agency programs that do not receive sufficient federal funding), Employment Security has historically relied on two state resources:

- The Administrative Contingency Account (Fund 120, also known as Penalties and Interest, or P&I).
- The Employment Services Administrative Account (Fund 134, also known as the Claimant Placement Program, or CPP).

P&I receives revenues from penalties and interest from employers that file late or incorrect unemployment taxes and interest from UI recipients who must repay benefits to which they were not entitled.

CPP was established in 1985 and receives its revenues from an employer tax of 0.02% of taxable wages (for most classes of employers). This funding source was established to augment federal funds to support employment programs.

These accounts provide funding to support ongoing reemployment efforts, maintaining systems and technology that support the UI and employment programs, compliance activities, data collection and analysis, and other mandatory programming.

Summary of funding

State fund projections

The following projection for the state funding sources, P&I and CPP, will continue to support the federal funding gap to deliver services. Expenditures of both funds decreased during the pandemic as the agency redeployed staff to support the UI program and were funded with either UI or CARES Act (federal COVID-19 response) funds. Since the pandemic, however, state expenditures have been increasing.

In June 2024, Employment Security's Office of Actuarial Services projected an increase in revenue for SFY2026 and SFY2027 based on expected growth in employer taxable wages. Projected expenditures include a 3% annual increase due to inflation.

FIGURE 4: CPP- Fund 134 Projections, rounded to thousands*

	FY2024	FY2025	FY2026	FY2027
Beginning balance	$57,327	$55,802	$44,974	$49,618
Revenue + Projections	$43,716	$41,659	$42,970	$44,297
Expenditure + Projections*	$45,242	$52,486	$38,327	$38,340
Ending balance	**$55,802**	**$44,974**	**$49,618**	**$55,574**

FIGURE 5: P&I- Fund 120 Projections, rounded to thousands*

	FY2024	FY2025	FY2026	FY2027
Beginning balance	$44,686	$42,855	$37,858	$37,716
Revenue + Projections	$17,504	$16,425	$17,122	$17,840
Expenditure + Projections*	$19,335	$21,423	$17,263	$18,126
Ending Balance	**$42,855**	**$37,858**	**$37,716**	**$37,340**

*Expenditure projections assume base funding only, at current levels. Decision package requests and other new funding items are excluded.

Post-pandemic trends in the UI environment

The impact of the COVID-19 pandemic on the UI program was unprecedented. The years of the pandemic stand out as outliers in the agency's revenue and expenditure history, and still those impacts continue to drive ongoing work demands. Before the pandemic, Employment Security received an average of 25,000 UI claims per week during peak months. In comparison, during the pandemic, the agency received on average 213,000 claims per week. Although the number of current weekly claims are near pre-pandemic levels, UI claims operations have not returned to normal, and the need to find and redefine a new "normal" is required based on current customer demands and operational needs.

The federal response to the pandemic included the launch of five unique pandemic-related unemployment programs. As a result, more benefits were paid out in the first 18 months of the public health emergency than the prior 18 years combined. Employment Security's pre-pandemic internal processes were neither designed to operate in a crisis, such as the pandemic, nor did it have the capacity to rapidly implement new programs with vastly different requirements that constantly evolved during the pandemic as USDOL issued over 70 pieces of guidance.

In a typical counter-cyclical revenue cycle, the agency expands in size to manage the increased unemployment workload, then contracts once unemployment rates stabilize. When unemployment rates are high, USDOL typically provides more funding to support operations during the period of economic crisis. Indeed, during the pandemic, Employment Security drastically and rapidly increased in size, not only to manage the increased UI workload, but also to respond to unprecedented identity theft and fraud issues. The UI program reduced from 1,669 FTEs at the height of the pandemic in 2021 to 874 FTEs in 2023 when most pandemic-era grants ended.

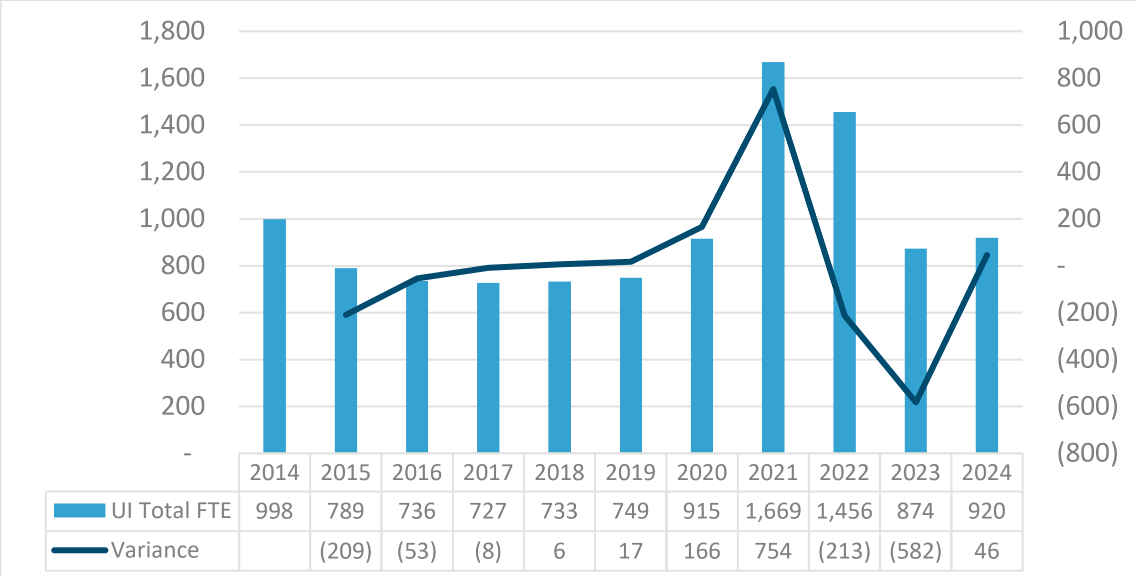
Employment Security organizational restructure

Employment Security has focused post-pandemic efforts on aligning work streams to reflect a growing agency and changed body of work. Notable differences in organizational structure, comparing 2019 to 2024, include:

- Established the Customer Compliance Division, consolidating the UI and Paid Family and Medical Leave (Paid Leave) programs' audit, collections and fraud lines of business. Growth in total customer compliance FTE occurred during this period, driven by an increase in fraud staff, including current non-permanent positions.
- Grew and refined an agency Product, Planning, & Performance Division to help prioritize and manage large UI projects with customer impacts, as well as standardize product development to enhance customer experience. This work accounted for the addition of 11.5 new Project, Product and Change Management FTEs to lead this work.
- Grew Information Technology staffing to support functions directly serving UI customers, as well as positions that support agency operations. Employment Security transitioned from reliance on contractors to agency employees to operate IT systems. These changes accounted for 20 permanent FTE.
- While a net growth of UI customer service positions occurred during this period, the establishment of a dedicated Pandemic Overpayment Team accounts for 56 of the new positions. Those positions are all temporary staff working solely on adjudication of remaining pandemic-era overpayments.

Administration of the UI program has increased by a total of 171 FTE, across all fund sources, from 2019 to 2024 (see Figure 6 for a more robust history).

FIGURE 6. UI program FTE levels and annual change*



	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024
UI Total FTE	998	789	736	727	733	749	915	1,669	1,456	874	920
Variance		(209)	(53)	(8)	6	17	166	754	(213)	(582)	46

*27.6 of the 46 FTE totals in 2024 are for Overpayment Waiver one-time project that expires 6/30/25

Post-pandemic consumer demands and operational changes

Although total weekly claims have stabilized to near pre-pandemic levels, the workflow has not stabilized to the same degree. Both call volumes and wait times remain elevated as the 2023 call volume was 97% higher than 2019. Key factors impacting workload today include:

- Customer behaviors and expectations have changed. More individuals prefer to call for service rather than access self-service resources online. Call metrics indicate 20% of claimants wish to engage with the UI system by phone only. More customers are requesting direct assistance when filing a claim, including increases in requests through both incoming phone calls and web notices.
- Employment Security established fraud protection measures to combat sophisticated identity fraud attacks that arose during the pandemic and continue today. Identity verification requirements mean an additional step for many claimants compared to pre-pandemic. Identity verification drives wait times and call volumes for all claimants.
  - Appeals to the Office of Administrative Hearings (OAH) increased by 35% since 2019. The top reasons for increased appeals are identity verification, able and available, and work search issues arise on claims. Employment Security made changes to the benefit application system that have resulted in reduced work search appeals and is exploring options to further reduce appeal rates.
  - Technology systems were disrupted by rapid pandemic-era changes. The UI program relies on two IT systems: the Unemployment Tax and Benefit (UTAB) system and the

Next Generation Tax System (NGTS). UTAB is the state's system for paying unemployment insurance benefits to workers. NGTS is the state's system for collecting taxes from employers. Both systems require ongoing IT support to resolve impacts from rapid changes made during the pandemic period.

- Personnel costs to support the changing customer needs and post-pandemic workloads are growing (Figure 7). The state invested $2 billion in compensation growth for state employees during the 2023-25 biennium. Cost-of-living adjustments and other collectively bargained incentives were provided to classified and management staff (Figure 8). Concurrently in 2023, Employment Security staff collectively bargained a new job class for the UI customer service teams, which increased compensation by an additional 5%. The RJM does not factor cost-of-living increases, which further widens the gap between budgeted need and federal revenue. The state does not fund collective bargaining agreement adjustments with general fund-state dollars in the Employment Security budget. Those costs are absorbed by Employment Security's state and federal accounts.

FIGURE 7: Average annual cost by FTE, by year. Expenditures rounded to thousands.

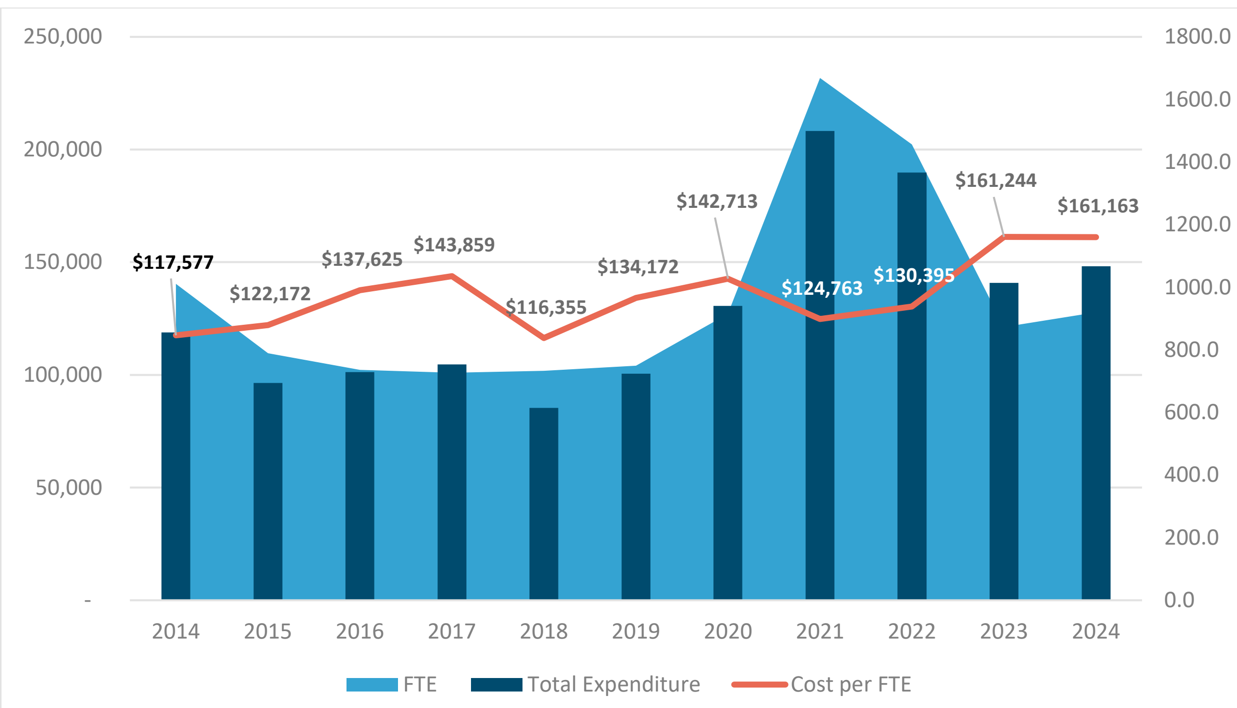
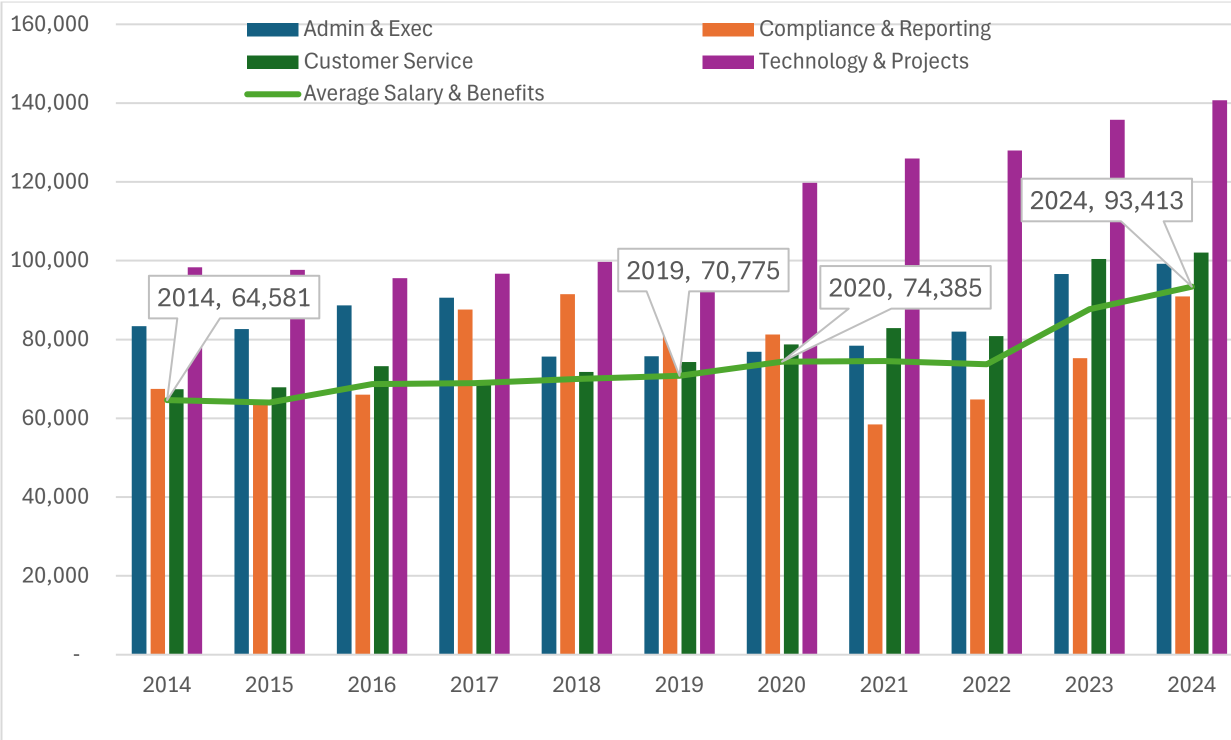


FIGURE 8. Average annual personnel cost by function



The changing face of fraud management

The fraud landscape has changed and become more sophisticated since the COVID-19 pandemic.

- Identity fraud has increased significantly compared to pre-pandemic years (Figure 9). The volume of potential fraud is not expected to drop to pre-pandemic levels as the UI program has become a popular target of identity fraud. Identity fraud investigations are complex, requiring the use of several crossmatches and fact-finding activities to make the appropriate determination. As artificial intelligence (AI) becomes more prevalent and sophisticated, criminals are continually finding more ways to attempt fraud.

FIGURE 9. Increase in identity fraud investigations

Fiscal year	Total fraud investigations	Identity fraud investigations	% identity fraud investigations
2019	48,844	7,093	15%
2021	465,447	369,664	79%
2024	126,096	96,736	77%

- Employment Security uses many tools and crossmatches to detect and prevent fraud. With the exponential increase in the speed and variety of fraud activities, Employment Security must enhance monitoring and technology capabilities to detect and prevent fraud and ensure timely access to those who legally qualify for benefits. Agency processes and systems were designed before identity fraud became prevalent and must be updated to address today's challenges.
- The Office of Special Investigations expanded using pandemic-era grants, increasing the base level of FTEs needed to manage fraud from 31 to 50 (2019-2024) after peaking at about 130 FTE at the height of the pandemic. That funding has ended, but additional project positions are still needed to prevent backlogs, which delay UI benefit payments. USDOL has not adjusted for the new costs of fraud to state agencies, even while pressing upon states the need to prevent fraud using its recommended tools.

Implementation of the GF-S investment

The General Fund-State investment was used to maintain personnel and contract costs for the technology systems that support the UI program. Personnel costs make up 89% of monthly UI expenses. Remaining funds were used to maintain contract requirements with UI technology vendors – specifically, UTAB and NGTS.

Long-term sustainability plan

Employment Security was directed to include in this series of reports strategies to address future decreases in federal funding. In the immediate term, Employment Security has sought to address the shortfall through program efficiencies, where possible. For the long term, Employment Security is proposing additional state funding authority to increase administrative funding. The agency will continue to monitor the state fund balance while using this authority.

Program efficiencies

Employment Security has implemented the following program efficiency measures:

- Cross-trained UI agents on both adjudication and intake functions to provide flexibility to adjust to business needs.
- Implemented a "call back" option for customers to get a call back on the same day.

- Launched a new phone system in April 2023 for increased call management efficiency and flexibility.
- Optimized the technology system to reduce staff time for processing claims, which resulted in improved efficiency, gaining thousands of FTE hours.
- Updated letters and instructions to claimants to reduce confusion and improve outcomes.
- Updated employer technology systems, which has reduced the number of claimant issues coming from this source.
- Increased claimant access to dual-language agents, reducing the need for translation services and increasing by 87% the number of Spanish calls handled by agency staff.
- Implemented measures to reduce the percentage of ultimately eligible individuals flagged for fraud by 16% in the last year, resulting in more timely benefit payments and reduced workload for staff.