John Locke Foundation

spotlight

No. 418 – January 13, 2012

First, Stop the Bleeding

Getting North Carolina Out of Its Unemployment Insurance Crisis

KEY FACTS: • Since the onset of the Great Recession, North Carolina's Unemployment Insurance (UI) administrators have vastly outspent revenues and generated a debt of $2.6 billion with the federal government—the third-highest in the nation, on a per-capita basis.

• The state's debt continues to grow at an annual rate of $178 million and generated its first interest charge of $78 million in September 2011.

• After three years of delinquency, the state faces a 0.3 percent punitive tax imposed by the federal government on N.C. wage income, starting in January 2012. That tax will step up in additional 0.3 percent increments every year until repayments begin.

• The state's UI benefit generosity exceeds that of all four neighboring states and also, on average, the after-tax remuneration of a minimum-wage job.

• Since 2007, the average length of UI payments has increased by 25 percent. And since initiation of the UI scheme in 1935, the maximum period of eligibility has grown by 519 percent and has almost reached two years.

• North Carolina's UI tax burden as a percentage of income is roughly equal to Tennessee's, but both surpass that of South Carolina, Georgia, and Virginia, by 48 percent or more.

• The United States Department of Labor estimates that 8.9 percent of North Carolina's UI payments are in error, which equates to $125 million annually.

• The federal government's full funding of Extended Benefits, through to 99 weeks and at an annual cost of $424 million in North Carolina, runs out on March 6, 2012.

• Cutting state-funded weeks for UI eligibility from 26 to 20 would save between $230 million and $440 million annually and close the current shortfall immediately.

• A reduction in North Carolina's UI benefits to match those of South Carolina would save an additional $250 million. Combined with the federal tax penalty and fewer weeks of eligibility, it would pay off the state's UI debt within six years.

• As of October 2011, the federal government has mandated interest penalties on all UI benefit overpayments on account of fraud, although that penalty will not go into force until October of 2013.

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The many nuances of the UI system mean that without a brief explanation one may struggle to understand the severity of the current scenario or the basis for disparities across states. Here are a few basic points, but if one would prefer a deeper examination, please see "Unemployment Insurance Taxes: Options for Program Design and Insolvent Trust Funds," a 32-page paper from the Tax Foundation.[1]

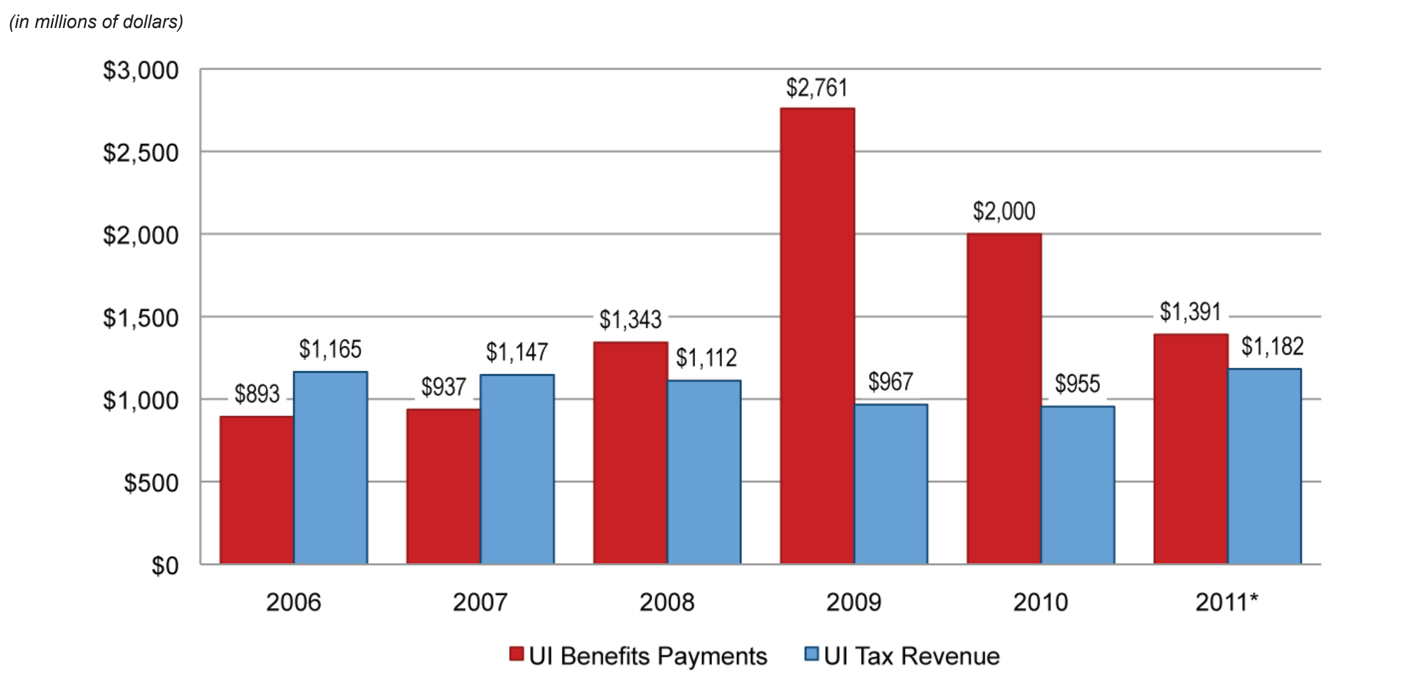
Originating with the 1935 Social Security Act, the purported goal of the UI system is to provide welfare payments to individuals who are "unemployed through no fault of their own."[2] It is a joint federal and state program with two streams for both revenue and expenditure.

Federal officials impose a uniform, nationwide tax of 6 percent on the first $7,000 of each employee's wages, paid by employers. However, if the state's UI program has U.S. Department of Labor's approval, the federal government refunds 5.4 percent to employers for an effective tax rate of 0.6 percent.[3] That comes to $42 for each worker and a total of $5.5 billion annually.[4] All states, along with the District of Columbia, Puerto Rico, and the Virgin Islands, have approved programs, and the residual 0.6 percent tax goes to reimburse each state's administrative expenses.

State officials, who carry out the direct provision of the UI payments, impose an additional tax on wages within their state. Employers pay varying rates, depending on their history of layoffs, and that money goes to a federally maintained trust fund for each state's UI payments. In North Carolina, that tax comes from the first $19,700 worth of wages, and a new employer pays 1.2 percent while employers with a high turnover can pay up to 6.8 percent.[5]

During periods of low unemployment, a state's UI trust fund will tend to accumulate reserves beyond the need for payments. On the other hand, during periods of high unemployment, payments may exceed revenues and the trust fund will dwindle. Since the Great Recession, most states' reserves have proved insufficient in the face of prolonged, high unemployment. That has pushed the trust funds into negative, and state officials have chosen to borrow from the federal government to make up the shortfall. In 2009 alone, for example, North Carolina's UI administrators paid out $1.8 billion in excess of available tax revenues.

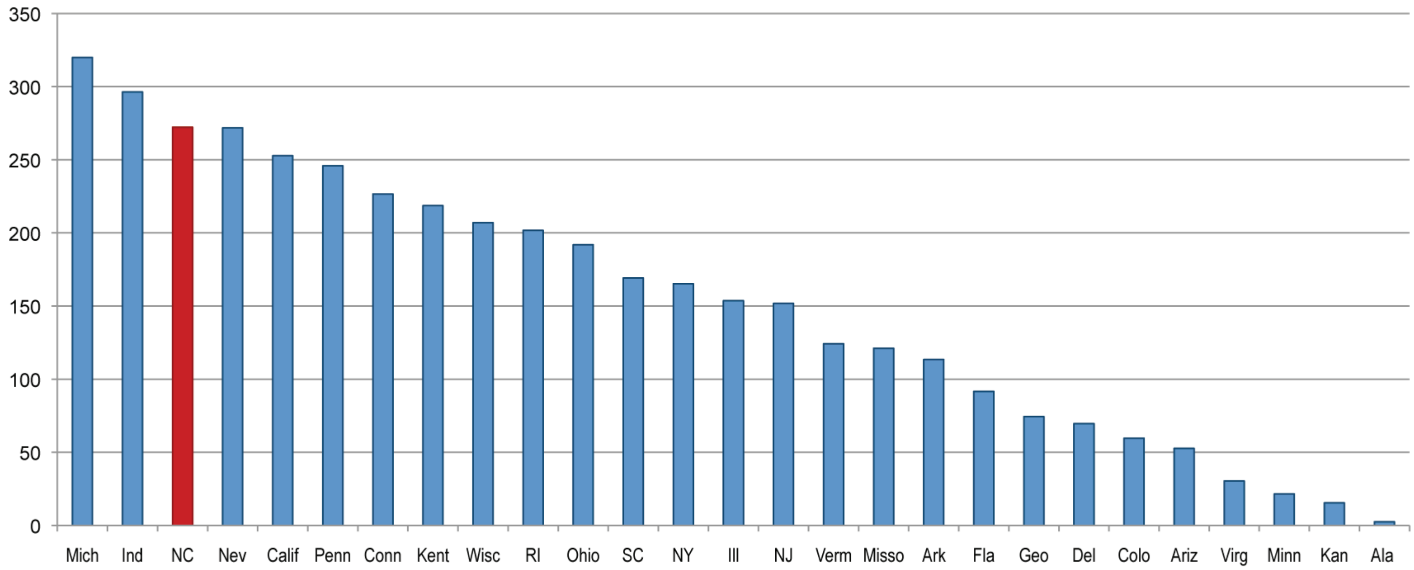
Figure 1. North Carolina UI Revenue vs. Benefits Paid



Source: North Carolina Division of Employment Security

** 2001 numbers are projected based on flows through October.*

Figure 2. Debts Owed to the Federal Government By States for UI Benefits



Source: United States Department of Labor

In addition to flexibility with a state's tax formula, the UI system entails flexibility in terms of each state's application of program benefits. That includes the dollar value of benefits, the number of weeks available, the eligibility requirements, and program enforcement. So the state-to-state trust fund disparities are a function of those policy variations, along with the economic climate that has contributed to more or fewer recipients.

Federal involvement complicates the picture further, though, since during times of greater unemployment, congressional representatives may offer additional weeks of benefits. These are over and above what the states offer, normally 26 weeks, and currently bring the total level of benefits to as high as 99 weeks. That includes the Emergency Unemployment Compensation fund and the Extended Benefits (EB) program.

For now the federal government funds additional benefits entirely. That has not always been the case, however, and congressional representatives have recently approved a three-month, stop-gap extension for the expanded period of eligibility.[6]

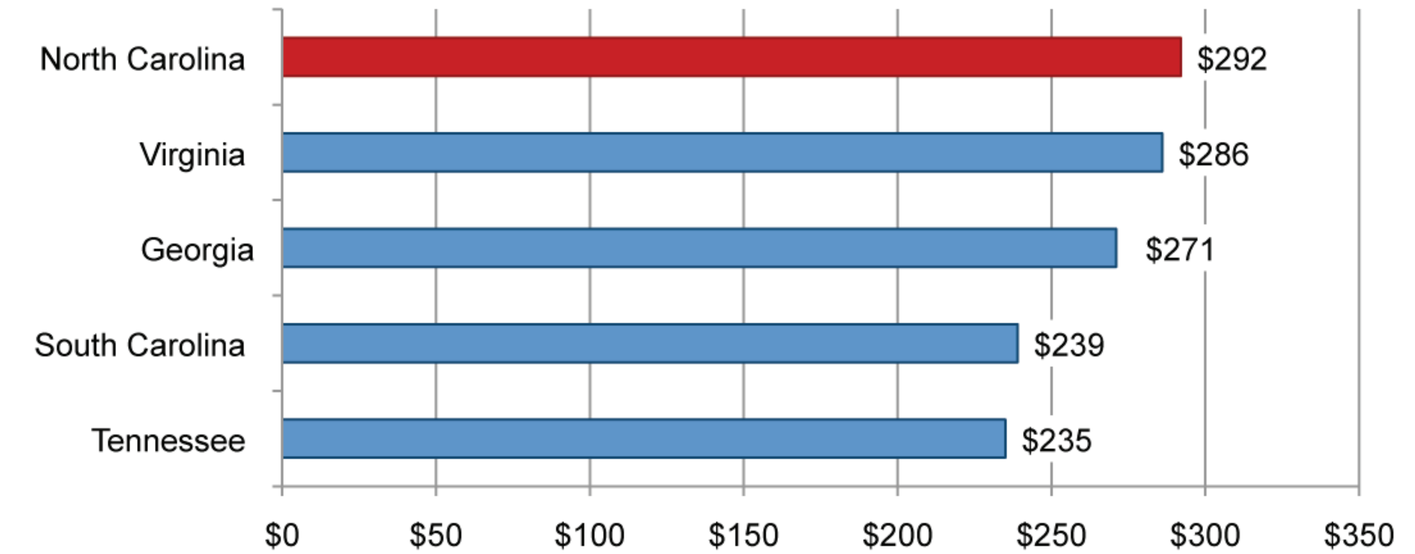
Time for Action

Since January 2009 and the onset of the Great Recession, North Carolina's Unemployment Insurance (UI) system has generated a debt of $2.6 billion with the federal government.[7] On a per-capita basis—$272—that debt is higher than those all of the state's neighbors and the third-highest of the 27 states with a UI debt to the federal government.[8]

The situation requires urgent attention, and in spite of the state's balanced-budget amendment,[9] the UI debt continues to grow at an annual rate of $178 million.[10] After more than two years of non-payment to the federal government, the debt also generated its first interest charge of $78 million on September 30, 2011 (a 4.1 percent interest rate for the first nine months of the year) and all but wiped out the state's own UI reserve fund.[11]

If the UI debt is left unpaid, then not only will interest continue to accrue, but also North Carolina employers will face higher UI taxes. Already, beginning this month, federal officials are imposing a 0.3 percent addition to the prevailing 0.6 percent federal UI tax (for administration costs). And that tax will continue to step up in additional 0.3 percent increments every year until repayments begin.

Figure 3. Average Weekly Uninsurance Benefit, North Carolina and Neighboring States (2nd Quarter 2011)



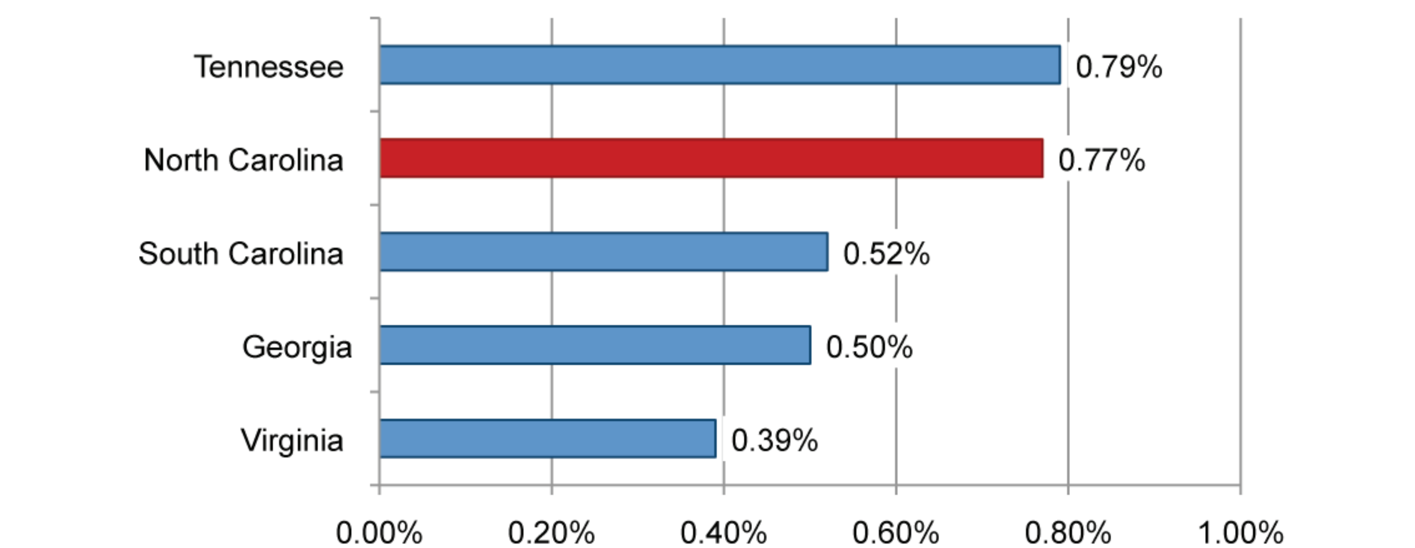
Source: Tax Foundation

North Carolina's UI Generosity and Taxation

The average weekly UI benefit in North Carolina is $292, more than those of all four bordering states. More specifically, it is 22 and 25 percent more than the average weekly UI benefits in South Carolina and Tennessee, respectively. These benefits also greatly exceed the after-tax remuneration of $230 for a full-time minimum-wage job in North Carolina.[12]

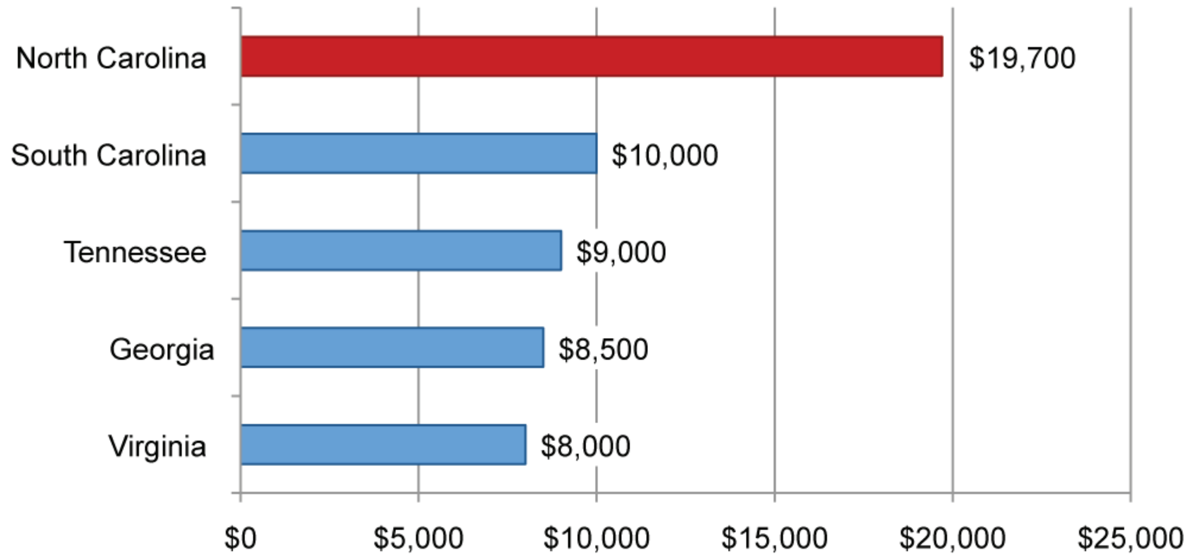
That is not to say, necessarily, that the benefit level has been rising. Since 2006, the generosity of each weekly payment has remained constant after inflation—an average of $287.76 versus $287.57 in 2010. (For 2009 and 2010, the federal government did fund a temporary across-the-board benefits boost of $25.)

Figure 4. Average Unemployment Tax Rate As a Percent of 2010 Wages, NC and Neighboring States



Source: Tax Foundation

Figure 5. Taxed Wage Base, North Carolina and Neighboring States (October 2011)



Source: Tax Foundation

The average length of payments, however, has increased by 25 percent between 2007 and 2011, from 13.7 weeks to 17.1 weeks.[13] The period of eligibility has also increased from a maximum of 73 weeks in 2007 to the 99 weeks on offer now, on account of federal legislation. That compares with the original maximum of 16 weeks, which resulted from the 1935 Social Security Act.[14]

On the taxation side, only Tennessee has a slightly higher UI burden as a percentage of wages, 0.79 versus 0.77 percent. Georgia, on the other hand, has a similar level of unemployment—10.3 versus North Carolina's 10.5 percent—and its tax burden is 0.50 percent.

At $19,700, North Carolina's taxable wage base for UI is also almost double that of all of its neighbors. South Carolina is the next closest with a tax base going up to $10,000. So North Carolina tends to have a lower marginal UI tax rate than its neighboring states (although the precise rate depends on employer history), but the higher level of taxed wages more than makes up the difference.

Reform Considerations

Any policy change must first address the outstanding debt and the ongoing UI shortfall. In attacking that target, though, other considerations enter the frame. Legislators should not, for example, wish to promote greater unemployment inadvertently by either discouraging potential employers or by rewarding idleness. Such secondary impacts would simply negate the initial intent.

Legislators should also not seek to complicate and entrench UI further as a compulsory program with no room for either cost-saving innovations or pathways towards private, voluntary insurance options. It is, after all, a federal imposition of more than dubious constitutionality, similar to the 2010 health care reform's individual mandate. Just substitute "employment" for "medical" insurance. UI's complicated tax structure was an attempt by the architects at the time to evade constitutional concerns.[15]

Regarding local and private options, keep in mind that prior to the federal law of 1935, one state, Wisconsin, had already initiated its own version of UI, and private firms had sought authorization to provide it as well. In fact, organized labor was one of the original opponents, since its leaders saw UI as supplanting their own role.[16]

Additionally, alongside either UI tax hikes or benefit reductions, we can address the slackness in the program in terms of payment accuracy (e.g., money that goes to waste, wrong payments, and overpayments). The Labor Department estimates that 8.9 percent of the North Carolina's UI payments are in error.[17] In 2010, for example, the Employment Security Commission paid out $28 million mistakenly and was not able to recover it.[18]

While the Labor Department estimate for North Carolina is not high in comparison with estimates for other states, it is roughly equal to the current annual shortfall and provides one route for closing the gap.[19] Given $5.5 billion worth of funding for administrative costs nationally, there is at very least room for improvement and savings via accuracy of payments.[20]

Additional Tax Increases Off the Table

The federal government is already imposing increased UI taxes on North Carolina as the default recourse, an additional 0.3 percent on income for each year of delinquency. While the revenue increase of approximately $85 million in 2012[21] will not be sufficient to bridge the state UI fiscal gap, the question is over additional taxes, not retention of current tax levels. (The only ways around this tax increase would be an act of Congress or for the state to repay the money by borrowing from other sources.)

This federally imposed 0.3 percent tax increase means current employees will automatically pay for past UI benefits that exceeded the taxes set aside. In other words, earlier taxes, already high relative to neighboring states, and the trust fund did not warrant the generosity of benefits paid out over the past two years. To raise taxes now, over and above the federal requirement, would further impose the past fiscal irresponsibility on current workers.[22]

Any additional UI tax increase would increase the cost of labor for employers and discourage them from making new hires—particularly unwise during a period of high unemployment. In light of this concern, the Small Business and Entrepreneurship Council identified high UI taxes as a basis for North Carolina's poor public-policy friendliness.[23]

A tax increase would also be an expansion of the UI system's transfer that subsidizes abnormal employment scenarios that tend to rely heavily on employees with high turnover. That includes high-risk and seasonal industries, among others, and North Carolina is one of 16 states that provide UI benefits to seasonal workers.[24]

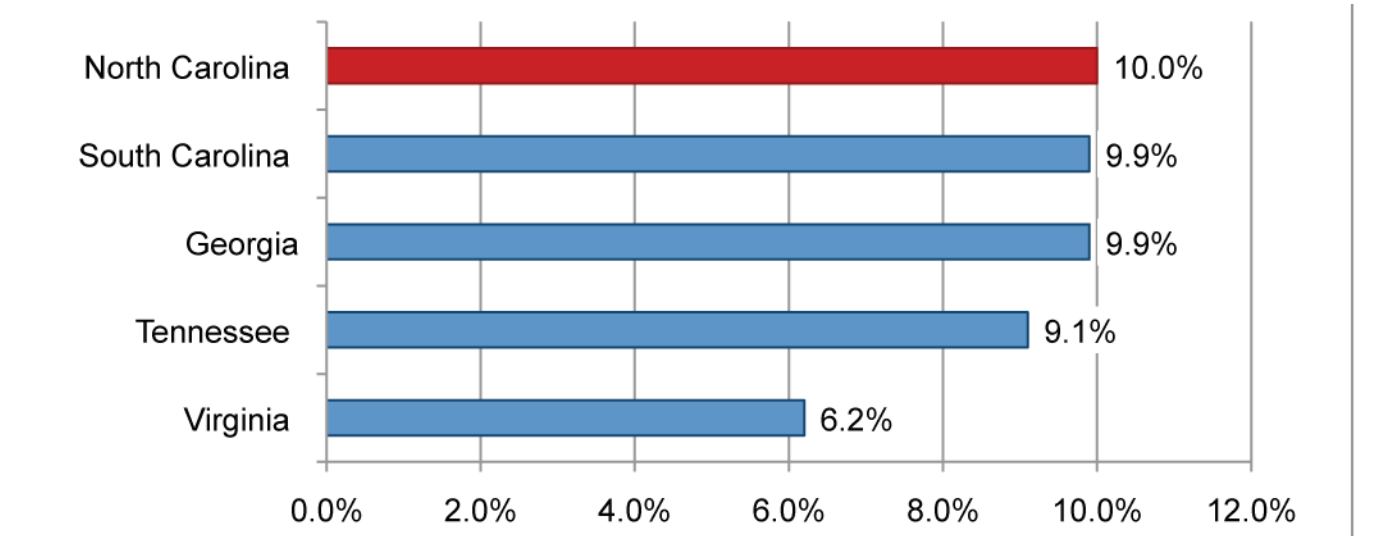
Some may be tempted to resolve this problem by taxing specific industries at higher rates or by ruling out all UI benefits to seasonal workers. Such attempts however, would complicate reporting requirements and open the doors for reporting fraud, as the U.S. Department of Labor has noticed, not to mention incessant and wasteful lobbying from trade associations.[25] If people wish to rectify what may be counterproductive spending on seasonal workers, simply allow workers in those industries to opt out.

Ways Legislators Can Close the Gap

Given the current desperation of North Carolina's UI trust fund deficit, one might be surprised to learn that it is poised to get worse. Currently, the federal government is financing the entire EB program for the 80-to-99-week period. That complete funding runs out on March 6, 2012, however, and it remains precarious.[26] Typically, states shoulder half of the cost—in North Carolina that would translate to another $212 million of annual UI payments.[27]

The 1935 UI program, in the middle of the Great Depression, began with benefits at only 16 weeks. Since then the period of total eligibility, given North Carolina's level of unemployment, has grown by 519 percent to 99 weeks. That level of coverage is simply unaffordable in the present context, particularly given that elected officials set aside nowhere near enough money to justify it.

Figure 6. State Unemployment Rates, North Carolina and Neighboring States (November 2011)



Source: Bureau of Labor Statistics

1. Reject any North Carolina participation in and funding of the 80-to-99-week EB period. That would not close the shortfall, but it would stop it from getting worse.

Aside from concerns for fiscal responsibility, legislators would find a sympathetic constituency. As the Civitas Institute measured in May of this year, even when the federal government funded the entire Extended Benefit program, only 53 percent of registered voters supported the 20-week extension.[28] Presumably, when North Carolina has to pick up the tab directly, that number would fall well below 50 percent.

2. Cut the number of exclusively state-funded weeks from 26 to 20. Assuming the EB program is rejected, that would bring the total period of eligibility to 73 weeks (18 months).

South Carolina and Missouri have recently led the way on cutting state-funded weeks. It would save between $230 million and $440 million annually in North Carolina.[29] Alone, that would not be sufficient to repay the debt—unless one were willing to wait more than twenty years for that to happen. It would, however, balance the UI trust fund shortfall, halt further federally mandated tax increases, and have a positive impact on the state's rate of unemployment.[30]

UI benefits have shown to lengthen periods of unemployment and increase the unemployment rate, and benefit reductions would dampen that relationship.[31] UI benefits raise the threshold for which the unemployed will accept a new role. That is to say, people are more likely to turn down an available job and hold out for a better-paid one—to engage in "excessive search"—so long as they can continue to receive benefits. As noted by the Tax Foundation, approximately one-third of recipients are able to find work within one week of exhausting UI benefits, while an increase in UI benefits of 10 percent would tend to raise unemployment durations by 4 to 8 percent.[32]

That may be hard to stomach, given an unemployment rate nationally of 9 percent, and 10 percent in North Carolina. This relationship between unemployment duration and unemployment benefits is well documented, however, and even supported by Larry Summers, President Obama's former director of the National Economic Council.[33]

One good example of the reluctant unemployed made news recently in Ashville, North Carolina, a county with 8 percent unemployment. A flower wholesaler could not find replacements for more than 60 illegal immigrants fired because of the E-Verify program. "Those who want to work fail to pass E-Verify, and those that pass fail to work," the owner shared.[34]

3. Adjust the payment formula to bring North Carolina's current benefit level into line with South Carolina's, from $292 to $239 per week.[35] At very least, bring it into line with North Carolina's bordering states, which average $258 per week.

A shift to South Carolina's level of benefit generosity would save $250 million annually, while a shift to the bordering states' average would save $160 million. The more aggressive approach, combined with the tax penalty of 0.3 percent and the restricted week eligibility, would pay off the debt within six years or by the end of the 2017 calendar year.[36] The less aggressive strategy, simply bringing benefits into line with those of neighboring states, would still pay off the debt within seven years, before the end of 2018.[37]

The current benefit calculation starts with the recipient's highest quarter's worth of wages from the previous year, so elected officials could adjust it to the average of all four quarters or make it equal to the second lowest quarter. Alternatively, if that calculation proved insufficient, the entire formula could be redesigned—ideally to an across-the-board entitlement, in line with a necessities-based income between jobs.

Such an income was the original intention for UI anyway, rather than maintenance of prevailing living standards.[38] Such a move to uniform benefits would also be in line with employer contributions. Everyone, high- and low-income earners alike, pays in at the same rate—at least everyone earning beyond $19,700. So to offer more generous payments based on higher income is unjustified.

4. Charge interest on benefit repayments where fraud has been found. The federal government has already mandated an interest penalty of 15 percent, to go into force in October of 2013. And the money must go directly back into North Carolina's UI system, rather than any other state fund.[39]

Currently, however, North Carolina does not charge interest penalties at all on UI fraud, and employee and employer wrongdoing accounts for about 70 percent of overpayments.[40] Also, the Division of Employment Security, while helpful in the preparation of this report, did not have a metric on how much of this money they manage to reclaim.

The U.S. Department of Labor has made the reduction of improper payments a priority and has provided $50 million to Georgia, North Carolina, South Carolina, and Tennessee to streamline and harmonize their UI information systems.[41] That update is due to be complete in 2013 and will assist with enforcement and accuracy.

Labor officials estimate North Carolina's current fraudulent and unauthorized overpayments at 8.9 percent of the total, which is below their target of less than 10 percent. If, however, a combination of improved information systems and stricter enforcement were to halve the overpayment rate—a more ambitious goal—that would save $63 million annually.

5. Lobby the federal government to loosen requirements to help with the UI fund's financial viability. Ideally, members of Congress would return this program to state jurisdiction entirely, but in the meantime, there are many unwarranted mandates that they could rescind painlessly.

One federal requirement, for example, is that beneficiaries be allowed to reject work as strike replacements or in roles they deem substantially inferior to other jobs in the area. Other than pandering to union support, this requirement doesn't appear justified. One-quarter of unemployed individuals reject roles that do not pay at least 10 percent more than their previous role. Handing out benefits so people can avoid jobs they consider beneath them was never the intent of the program.[42]

Concluding Remarks

While the state's UI trust fund debt has grown rapidly in a period of just two and a half years, relatively minor changes are all it would take to pay off this debt in six years. Further inaction would make the turnaround more difficult, but for now it would simply require putting North Carolina's UI eligibility and benefits in line with those of her southern neighbor.

Doing so would halt the growing imposition of debt on future workers not yet able to defend themselves in the political process, and it would avert further intrusion and mandatory tax increases from the federal government—the current default route. It would also promote employment by reducing the subsidy for idleness.

Tighter bookkeeping and prosecution of fraudulent claims also offer an opportunity for cost savings. An even easier alternative, though, would be to free up investment opportunities and the labor market to enable more lucrative employment opportunities. Of course, more government debt, an overly generous UI system, and mounting taxes on wages would do just the opposite.

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End Notes

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3. DOL, "Unemployment Insurance Tax Topic," *www.ows.doleta.gov/unemploy/uitaxtopic.asp*, accessed December 14, 2011.
4. DOL, "Unemployment Compensation: Federal-State Partnership," April 2011, p. 2, *workforcesecurity.doleta.gov/unemploy/pdf/partnership.pdf*.
5. *Op. cit.*, note 1, p. 7.
6. Ron Scherer, "Unemployment extension 101: what the payroll tax deal means for the jobless," *Christian Science Monitor*, December 23, 2011, *www.csmonitor.com/USA/Politics/2011/1223/Unemployment-extension-101-what-the-payroll-tax-deal-means-for-the-jobless*.
7. North Carolina Division of Employment Security (DES), "ESC Monthly Activity Reports," *www.ncesc1.com/pmi/activityRpts/activitymain.asp*.
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13. DES has changed its reporting format, so the 2007 number is from July to September, while the 2011 number is from the fiscal year—July 2010 to June 2011.
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16. *Op. cit.*, note 1, p. 6.
17. DOL, "North Carolina, Chart 1: Causes of Improper Payments," *www.dol.gov/dol/maps/state/NC.htm*, accessed December 13, 2011.
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27. DOL, "100% Federal Funding of Extended Benefits (EB) Extended to January 4, 2012," *www.ows.doleta.gov/unemploy/supp_act_eb.asp*, accessed December 14, 2011. The annual cost of UI payments was taken directly from the latest Employment Security Commission monthly update: 12 months x $35.3 million = $424 million; half of that is $212 million.
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29. Center on Budget and Policy Priorities, "Policy Basics: How Many Weeks of Unemployment Compensation Are Available," *www.cbpp.org/files/PolicyBasics_UI_Weeks.pdf*, accessed December 13, 2011.These estimates are from internal calculations based on recipient numbers from the North Carolina Division of Employment Security. Unfortunately, precise recipient figures for the 21-to-26-week period were not available, so an approximation was made using recipient rates from the first 26 weeks and the following 20 weeks. The maximum number was $437,768,736, going by recipient rate from the first 26 weeks, and the minimum number was $225,464,179, going by the recipient rate for the following 20 weeks.
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36. These calculations assume an interest rate of 4 percent (which the state paid this year), $85 million from the tax penalty, an annual $300 million gain from the shortened week eligibility (approximately $100 million after the $200 million current deficit), and then the $250 million dollar gain from a reduction in benefits to South Carolina levels.
37. This calculation uses the same assumptions expressed supra, except the annual gain from the benefit reduction is $160 million rather than $250 million.
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