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UI Financing Basics

Question: How are regular state UI benefits financed?

Answer: Benefits for employees of private employers are paid for by state UI payroll taxes. UI payroll taxes are not imposed on all wages. The portion subject to taxation is referred to as the “taxable wage base.” During 2015, state taxable wage bases ranged from \$7,000 (the federal minimum for states) to \$42,100. Seventeen states have taxable wage bases over \$20,000 (USDOL, 2015b.). All states have maximum and minimum UI tax rates. In 2015, minimum tax rates ranged from zero or near zero, to 2.8 percent of taxable wages. Maximum UI tax rates ranged from 10.89 percent of taxable wages to 5.4 percent (the lowest maximum state rate permitted under federal law) (USDOL, 2015c).

For historical and constitutional reasons, state and local governments and non-profits do not pay UI taxes. Instead, they are billed by state agencies on a quarterly basis for any UI benefits paid to their former employees. For this reason, they are known as “reimbursable employers.” In addition, three states (Alaska, New Jersey, and Pennsylvania) have small employee contributions that finance their UI programs. (Further details below.)

Regardless of their source, all forms of state UI contributions are required by federal law to be deposited in an account maintained for each state within the U.S. Treasury. States then draw down those deposits for the payment of UI benefits. Under this mechanism, UI financing is kept separate from state budget and tax policy disputes. The federal government pays interest on trust fund balances. In the event a state trust fund is insolvent, states can draw federal trust fund loans which they repay with interest. In recent years, several states have borrowed at lower interest rates in the bond market to repay federal UI debts.

Question: Is there a federal UI payroll tax?

Answer: There is a separate federal tax (called the Federal Unemployment Tax Act, or FUTA) that is paid annually to the Internal Revenue Service on a taxable wage base of \$7,000 by taxable employers. The current FUTA rate is 0.6 percent, or \$42 per covered employee earning \$7,000 or more in a calendar year. This small tax generates a few billion dollars, which is used to provide administrative funding to state UI agencies and the UI activities of the U.S. Department of Labor, and to build up funds for future federal benefit extensions. The FUTA tax does not finance regular state UI benefits. In addition, reimbursable employers do not pay the FUTA tax.

Question: Why is UI financing important to workers and advocates?

Answer: There is clear evidence that trust fund reserves protect UI benefits from attack by avoiding solvency crises, which triggered many negative changes in state UI programs since 2011. Advance funding of UI is much more important to jobless workers than generally believed in terms of the long-term viability and adequacy of UI programs. And, this belief has been reinforced by events in recent years where the worst state benefit cuts took place in states that had trust funds that were unprepared for the recession.

There is also clear evidence that states can prepare for recession by building trust fund reserves. In 2012, NELP published a new analysis confirming that states can avoid the worst impacts of trust fund insolvency by accumulating adequate trust fund reserves prior to recessions (Evangelist, 2012).

Question: How is UI trust fund solvency assessed?

Answer: “Solvency” concerns the assessment of a state’s accumulated trust fund reserves. The assessment of solvency is a combination of objective factors, risk evaluation, and value judgments. While somewhat obscure and technical, solvency is important in determining the overall health of UI programs. Less solvent states have incentives to adopt less generous benefits and more restrictive UI program eligibility. When faced with financial challenges during a recession, less solvent states are more likely to be tempted to restrict their UI programs in conjunction with any tax increases they are forced to impose on their employers. For these reasons, adequate UI trust fund solvency is a significant issue for protecting the interests of unemployed workers and the health of UI programs.

The Average High Cost Multiple (AHCM) was adopted in 1995 as a measure of UI solvency by the Advisory Council on Unemployment Compensation, a federal advisory panel. In essence, AHCMs compare the size of a state’s UI trust fund with past benefit payments—which represent the actuarial risk faced in future recessions. A state’s AHCM is calculated as the average of the three most recent high cost calendar years that include either three recessions or at least 20 years’ of benefit payment history. An AHCM of at least 1.0 was recommended by the Advisory Council. The AHCM figure can be translated into a time period that a state’s UI trust fund will cover its benefit costs without relying upon current revenue. For example, an AHCM of 1.0 means a trust fund has one year of reserves to cover its average highest benefit costs. An AHCM of 0.3 would translate to 4 months of reserves.

The U.S. Department of Labor publishes a helpful annual report, called Significant Measures of State UI Tax Systems that calculates an “adequate financing rate” for each state. The adequate financing rate is a concrete way to translate the 1.0 AHCM standard of solvency to a state’s tax effort, and shows how much higher taxes must be to reach solvency in five years. The adequate financing rate is calculated by comparing the past 10 years of benefits costs in terms of total wages and comparing those to the level of taxation required for each state’s trust fund to reach an AHCM of 1.0 within five years. (Details of the adequate financing rate calculation are found in the report’s Definitions section.)

Question: What is experience rating of UI payroll taxes?

Answer: Experience rating is a process through which UI payroll tax rates on contributing employers are adjusted in relation to layoffs of individual firms’ employees or former employees. In other words, as UI benefit payments to a firm’s laid off employees rise, tax rates on the firm are increased in subsequent years. Conversely, in the absence of

UI benefit payments, UI payroll tax rates on employers fall. Thus, based upon the firm’s “experience” with unemployment, its tax rate is more or less determined between the limits set by minimum and maximum rates in state UI law. (In addition to individual firms’ experience rates, many states adjust UI payroll taxes according to other factors, including the overall health of trust fund reserves.)

The U.S. is the only nation with an advanced economy to use experience rating to finance UI (Vroman, 2012: 7-8). All states have adopted experience rating in order to meet federal requirements providing a FUTA tax credit for employers whose wages are subject to a state UI experience-rated tax. While all states have UI experience rating in order to satisfy this requirement, there is considerable variation in how states implement it. First, states vary according to the portion of wages subject to UI taxes (known as a taxable wage base), their minimum and maximum UI tax rates, how fast their tax rates adjust within the resulting range of rates (usually from three to five years), and the experience rating formula used. Second, the mix of these state policies impacts the degree to which a state’s experience rating method “effectively charges” benefit costs to a particular firm and recovers those costs for its trust fund.

In the real world, “perfect” or “complete” experience rating—where every benefit dollar is collected from the specific employer involved—is not possible. Nor is perfect experience rating desirable. The simplest explanation for this is that some firms with high experience would be hurt competitively by UI taxes if they were required to bear the full costs of UI benefits paid to former employees. On the other end of the experience rating scale, since all employers have employees insured by UI programs, all employers should pay some minimum UI tax (in effect, an insurance premium) to reflect the social benefits of UI programs to each firm, their employees, and the overall economy. For this reason, zero or near-zero minimum tax rates are bad policy.

In sum, with respect to experience rating, a reasonable goal is to determine the mix of tax policies that a state’s policymakers and interest groups find acceptable in order to finance its UI program. An unreasonable goal is to try to keep adjusting UI taxes in a futile effort to reach complete or perfect experience rating or to avoid upward tax adjustments required to properly finance UI programs.

Question: What is an “indexed” taxable wage base?

Answer: Seventeen states automatically adjust their taxable wage bases with growth in state wages, a practice called “indexing” (USDOL, 2015a). Having a higher taxable wage base and indexing that tax base are two important policies that have contributed significantly to states’ UI trust funds remaining solvent over the years. In addition, having a higher taxable wage base permits more effective charging under experience rating, something that many employers and economists claim is a worthwhile policy, but often oppose in practice by arguing for lower rates and lower taxable wage bases.

Indexing or raising a state’s taxable wage base is the single most important UI financing step that a state can take to move toward responsible UI financing. In some states with low taxable wage bases, less than one third of total wages are even subject to UI taxes. This makes it virtually impossible for UI experience rating mechanisms to adjust

to higher benefit payments, meaning that UI trust funds do not rebuild during economic recovery periods in time for the next recession.

Question: What is the role of employee contributions in UI financing?

Answer: In the U.S., states have always had the option of imposing UI employee payroll taxes, but very few have done so. Currently, three states (Alaska, New Jersey, and Pennsylvania) have state employee contributions for UI financing. In Alaska and New Jersey, the employee UI tax is imposed on each state’s UI taxable wage base (in 2014, Alaska, \$37,400; New Jersey, \$31,500). In Alaska, the employee tax rate is set at 27 percent of the average benefit cost rate imposed on employers, and falls between 0.5 percent and 1.0 percent (or a maximum \$37.40 per employee a year). In New Jersey, the employee tax for UI is currently 0.3825 percent (or \$120.50 a year for an employee earning \$31,500 or more), and is a smaller component of a larger combined employee tax that funds workers’ compensation and Temporary Disability Insurance in addition to UI benefits. In recent years, employee contributions have provided about 20 percent of UI trust fund revenues in New Jersey. In Pennsylvania, the last state to adopt UI employee contributions in the 1980s, the contribution is imposed on total wages and ranges from zero to 0.08 percent, depending upon the solvency of the state’s trust fund. The employee rate for 2014 in Pennsylvania was 0.07 percent, or \$31.50 for an employee earning average wages of \$45,000.

Question: What are the arguments for employee contributions for UI benefits?

Answer: There is general agreement that a significant portion of any employer portion of payroll taxes effectively fall on employees in the form of lower wages (Fullerton, 2002: 1), although economists debate the exact degree to which this happens. Despite this economic reality, under the current U.S. UI funding mechanism, employers largely rule politically simply because they write the checks for state UI taxes. And, in the eyes of employers and legislators, employers “own” the UI program. Paying a portion of the UI payroll taxes directly will make employees partial owners of the UI program, which would be an advance over the current political climate around UI issues. In addition, the burden of paying part of the costs of UI benefits is more easily shared among all working employees, rather than the smaller group of jobless workers who “pay” by suffering from low benefits or cuts in duration.

Resources:

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- Mike Evangelist, "Lessons Left Unlearned: Unemployment Insurance Financing After the Great Recession," Policy Brief, National Employment Law Project (July 2012).
- Don Fullerton and Gilbert E. Metcalf, "Tax Incidence," NBER Working Paper 8829 (March 2002), <http://www.Nber.org/papers/8829>.
- Phillip B. Levine, "Financing Benefit Payments," in O'Leary, C.J. and Wandner, S. A., Unemployment Insurance in the United States: Analysis of Policy Issues (Upjohn Institute, 1997), pp. 347-353.
- Wayne Vroman, "The Challenge Facing the UI Financing System," Urban Institute Working Paper 3 (August 2012), <http://www.urban.org/sites/default/files/alfresco/publication-pdfs/412629-The-Challenge-Facing-the-Unemployment-Insurance-Financial-System.PDF>.
- U.S. Department of Labor (USDOL), Comparison of State Unemployment Insurance Laws, Chapter 2, "Financing." (2015a), <http://workforcesecurity.doleta.gov/unemploy/pdf/uilawcompar/2015/financing.pdf>.
- Significant Provisions of State UI Laws, Effective July 2015 (2015b), <http://workforcesecurity.doleta.gov/unemploy/content/sigpros/2010-2019/July2015.pdf>.
- Significant Measures of State UI Tax Systems 2014, (2015c), <http://workforcesecurity.doleta.gov/unemploy/pdf/sigmeasuitaxsys14.pdf>.