

Build Trust Funds in Advance to Prepare for Benefit Costs Incurred During a Recession



What is it?

All state UI financing mechanisms set UI tax rates based on a combination of an individual employer's layoff history (experience rating) and the overall condition of the UI trust fund. A critical element of prudent UI financing is whether the funding mechanism used provides for the accumulation of adequate reserves which will be needed in periods of high unemployment. Those systems that are known as forward financing use flush economic times to build up the trust fund for hard times. In contrast, pay-as-you-go financing mechanisms set trust fund balances at a fixed amount or based on recent UI benefit expenses and miss an opportunity to adequately prepare for hard times. States should use a forward financing measure and choose one that is either related to the amount of UI benefits costs that would be paid in an economic downturn or the total wages paid by employers in the UI system.



Which states use various financing models?

Forward financing

Fund Adequacy or High Cost Multiple Method: Iowa, Oregon, Idaho, Hawaii and Vermont are among the states that base their UI taxes on a fund adequacy ratio or high cost multiple method. In Iowa, for example, this ratio compares the reserve ratio (the trust fund balance as a percent of total wages in the economy) to the highest benefit cost ratio (total annual benefits as a percent of total wages) of the past ten years. This measures whether the current trust fund has enough reserves to pay for an unexpected recession that would cause benefits to be paid out at as high a rate as any time in the past 10 years. Critically, the measure adjusts for the economy's size by measuring both reserves and benefits costs as compared to all the wages insured by UI. Iowa provides a series of tax schedules that charges its highest tax rates when the trust fund is low and could only pay four months of peak benefits out of its reserve, and its lowest UI tax rates when the trust fund is flush and reaches 1.3 years worth of reserves. Each tax schedule sets an individual firm's rate according to its experience rating.

The Advisory Council on Unemployment Compensation recommended that states should have trust fund balances sufficient to provide for at least a full year of benefits during a time of recession-level costs; this is known as an average high cost multiple of 1.0. Thus, if a state pays UI benefits averaging two percent of all wages in the state during recessions, it would need to have a trust fund balance equaling two percent of all wages to achieve a high cost multiple of 1.0.

Several other states (like New Jersey) use a reserve ratio alone (trust fund as a percent of wages in the economy) as the trust fund measure to determine which tax schedule is in effect that year. While less preferable to a high cost multiple method, such methods can also promote forward financing when they are allowed to operate as intended.

Examples of State Using Forward Financing

Hawaii
Idaho
Iowa
Oregon
Vermont

Pay-as-you-go methods

- **Fixed dollar amounts:** Some states, such as Minnesota and Illinois, only increase UI taxes when the trust fund falls below a fixed target amount. For example, Minnesota adopted a \$300 million trust fund target in 1987 that was left unchanged through 2002. With wages rapidly growing in the state due to inflation and economic growth, the target amount quickly became insufficient as an indicator of trust fund health and sufficient reserves were not accumulated in the 1990s.
- **Current Benefits:** Pennsylvania aims to have a trust fund balance equal to the most recent three years of UI benefit costs. Thus, when unemployment is low and UI benefit payments dip, trust fund balances are kept down. This approach discourages savings during economic good times.



Key arguments in favor

States using forward financing are able to expand unemployment benefits when they are needed most. Due to prudent savings during the economic boom, Oregon was able to provide for a state extension of unemployment benefits when the state dipped into a long decline in 2001. Similarly, New Jersey was able to increase the length of regular unemployment benefits and extend coverage to part-time workers during 2001-2003.

States that don't build adequate trust fund balances face trust fund insolvency and UI benefit cuts during recessionary periods. With state UI trust funds facing insolvency in 2003 and 2004, jobless workers in states with high unemployment (for example, Pennsylvania and Illinois) saw their weekly UI benefit checks cut during the recession because their state had not saved enough in the trust fund in advance. A number of states (including Minnesota and Illinois) that had previously abandoned forward financing principles were forced to borrow from the federal government to pay regular benefits during the 2001-2003 jobs slump.



Key arguments against and responses to them

Opponents say: Higher trust fund balances take money out of the economy that is better left with employers.

Response: The federal government pays a handsome interest premium to states that accumulate trust fund balances – with the interest differential between higher and lower solvency states often equaling hundreds of millions of dollars. Thus, the money in the trust fund earns more money for the trust fund. More importantly, UI trust fund dollars can only be spent on UI benefits and are never lost to the economy. Because UI

recipients quickly spend all of their benefit checks on basic needs, UI benefits are an automatic shock absorber to local economies when hard times hit.



Model legislation

Iowa

2.d. The department shall determine the contribution rate table to be in effect for the rate year following the computation date, by determining the ratio of the current reserve fund ratio to the highest benefit cost ratio on the computation date.

(1) The current reserve fund ratio is computed by dividing the total funds available for payment of benefits, on the computation date, by the total wages paid in covered employment excluding reimbursable employment wages during the first four calendar quarters of the five calendar quarters immediately preceding the computation date.

(2) The highest benefit cost ratio is the highest of the resulting ratios computed by dividing the total benefits paid, excluding reimbursable benefits paid, during each consecutive twelve-month period, during the ten-year period ending on the computation date, by the total wages, excluding reimbursable employment wages, paid in the four calendar quarters ending nearest and prior to the last day of such twelve-month period; however, the highest benefit cost ratio shall not be less than .02.

If the current reserve fund ratio, divided by the highest benefit cost rate ratio:

Equals or exceeds in effect is	But is Less than	The contribution rate table
--	0.3	1
0.3	0.5	2
0.5	0.7	3
0.7	0.85	4
0.85	1	5
1	1.15	6
1.15	1.3	7
1.3	--	8

IOWA CODE § 96.7



Watch Out For: Imprudent UI Financing Schemes

A number of states seek to tinker with their core UI financing mechanisms, to lower taxes for certain groups of employers or, during a time when the trust fund appears flush, for all employers. While tax cuts sound popular, these unwise carve-outs undermine the overall self-funding mechanism of the UI system, and

eventually pass along the costs of economic downturns to other employers or workers. There are several schemes that state legislatures should avoid.

Zero minimum taxes: Several states have decided to give employers with a low experience rating (low-layoff employers) a zero tax rate, meaning that only a portion of the state's employers are contributing into the system. These zero tax rates often apply to a majority of employers in the state. This is not good public policy; every employer should make an annual contribution into the UI system. Such a minimal contribution covers the value of providing insurance to their employees in the case of unexpected layoffs or a business failure, and represents the benefit that the entire state gets by having a universal UI program.

Overrides of statutory tax triggers: In good economic times, state legislatures often are inclined to cut taxes. Cutting taxes is especially dangerous policy for UI, given the counter-cyclical nature of UI financing. During good times, the UI trust funds are filled so that the state has adequate rainy day reserves to pay benefits during recessions when demand is greatest. In order to cut UI taxes, legislatures have passed special legislation to override or suspend the actuarial tax schedules that were designed to build up revenues. Fooled by seemingly flush trust fund balances during growth cycles when jobless benefits are low, employers in these states have been gravely disappointed when they had to face large tax increases during recession and recovery periods, when they can least afford it. Once the legislature and constituents agree to a prudent structure, they should stick to it.

Tax holidays: The extreme version of overriding statutory tax triggers is granting tax holidays. Tax holidays give every employer a zero tax rate for the year. Not only does this violate the core principle of experience-rated UI taxes (with employers paying back a proportion of the benefits that their former employers receive), it wastes the precious opportunity to save for future recessions. Tax holidays are most disturbing when they are enacted in states with inadequate UI programs that provide benefits to a small share of the unemployed. If the UI program is not serving jobless workers well, UI taxes should not be so drastically cut.

Prepayment of taxes: Voluntary or pre-payment of unemployment taxes (allowed in 27 states) allows employers to artificially lower their tax rates. Here's how it works. An employer makes a UI tax payment in advance and thus increases the balance in their own account which is a historical ledger of benefits paid out to former employees as compared to the taxes that firm has paid. The flush balance makes it appear that the employer has a more modest experience rating. Because of the artificial appearance of a high UI balance, a lower UI tax rate is then assigned; the tax savings are greater than the amount of the employer's contribution. Employers argue that this is way to pay back those benefits charged against their account. The effect, however, undermines the concept of experience-rating. Experience-rated tax systems were set up to create tax rates that represent individual charges and the needs of the entire UI system. Pre-payment manipulates this system and eventually passes along costs to those who don't take advantage of this loophole. States should prohibit this practice.