

Adopt a Wide Range of UI Tax Rates



What is it?

By federal law, each state must vary the rate of unemployment insurance taxes an employer must pay based on each employer's past experience using the system, that is, the amount of UI benefit payments charged to each employer. Federal law requires that the top (or maximum) tax rate be at least 5.4 percent of taxable wages but states can set higher top tax rates and many states do so. When states set a wide range of tax rates and use higher top tax rates, the tax scheme better reflects employers' usage of the UI program. Such structures ensure that those employers who lay off the greatest proportion of their workforce pay their fair share into the UI trust fund, and vice versa. Moreover, this type of robust experience-rating system allows state trust funds to recover after they have been drained during periods of high layoffs.



Key arguments in favor

Unemployment benefit charges won't be properly distributed among employers if the range of tax rates is narrow and the top rate is too low. UI taxes are experience-rated, meaning that different employers face tax assessments that vary with their use of the UI system. The idea behind experience rating is that employers should have to pay back a proportion of the benefits incurred against their particular accounts. In every state, experience-rated taxes are capped at a top level set by state law. If the maximum rate is too low, there will not be a wide range of tax rates and high-layoff employers will consistently pay less in taxes than their former workers receive in benefits. Other employers and workers will have to make up the difference directly or indirectly – in higher UI tax rates for employers and lower benefits for workers.

Ineffective charges represent a large share of UI benefits. Some categories of employers use the UI system more than others due to periodic lay-offs. When the UI benefits drawn for a category of employers exceeds the amount of UI taxes paid into the system for the same category, this is known as ineffective charging. Ineffective charges represented nearly a quarter of all benefits paid in 2002. A narrow range of tax rates with a low maximum contributes to ineffective charging.

A robust tax schedule facilitates the recovery of state trust funds after recessions. Experience rating is one of the key mechanisms that states use to replenish their state UI trust funds after a recession, as tax rates automatically increase among those employers specifically involved in high unemployment. Adequate maximum tax rates allow the system to naturally recover a large proportion of the upsurge in UI benefits that occurs during a downturn. In states with a narrow range of tax rates and a low maximum tax rates, this

process is cut off because an employer cannot have a tax rate above 5.4 percent, even if their benefit charges have skyrocketed. In such cases, states either leave their trust fund depleted, force the legislature to come up with an ad hoc solution, or assess across the board taxes on all employers, that are not targeted based on the rate of layoffs.



Key arguments against and responses to them

Opponents say: I'm against all tax increases.

Response: Unemployment insurance is a self-financing system, and contributions must keep up with benefits. An experience-rating system with an adequate maximum is a key component to a tax system that fairly distributes these costs among employers. States with low maximum tax rates must find other ways to cover benefit costs.

Opponents say: I pay high enough UI taxes already.

Response: Some employers are not paying their fair share of UI taxes because low maximum tax rates result in ineffective charges. That means that many other employers are paying more than their fair share of UI taxes. Using a wide range of tax rates makes the system fairer to employers and may reduce the taxes of those employers who are not heavy users of the UI system.



Which states do it

All states have multiple tax schedules; the tax schedule in use for any given year depends on how flush the UI trust fund is. Each schedule contains experience-rated tax levels for employers with a maximum tax rate. Half of the states have a maximum tax rate of 5.4 percent under the state's most favorable tax schedule – that is, the one used when the trust fund is flush. Some 33 states have a maximum tax rate above 5.4 percent under the least favorable tax schedule, that is, the one what is used when trust fund balances are low.

References

EMPLOYMENT AND TRAINING ADMINISTRATION ADVISORY SYSTEM, U.S. DEP'T OF LABOR, UNEMPLOYMENT INSURANCE PROGRAM LETTER NO. 26-03 (2003), available at <http://www.ows.doleta.gov>.