

# Financing UI Benefits

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## Alaska's system differs from that of other states

**T**he Unemployment Insurance System in the United States was created as part of the Social Security Act of 1935. Under the act, each state administers its own program, subject to approval by the U.S. Department of Labor. The objective of the UI system is economic stability for both businesses and individuals. Since benefits are paid to unemployed workers, almost every dollar is quickly returned to the economy. This stabilizes both the business climate and the workforce.

This article reviews where the money comes from to pay unemployment insurance (UI) benefits. First, the UI financing system is discussed, with an explanation of benefit costs and the benefit cost rate. Second, the UI trust fund is described, along with a discussion of the general level and trends of employer and employee taxes. Third, the procedures for calculating UI tax rates, employer experience rating, and the trust fund solvency adjustment are explained. And last, program administration and revenue from direct reimbursements to the fund are discussed.

### Unemployment Insurance is a self-financing system

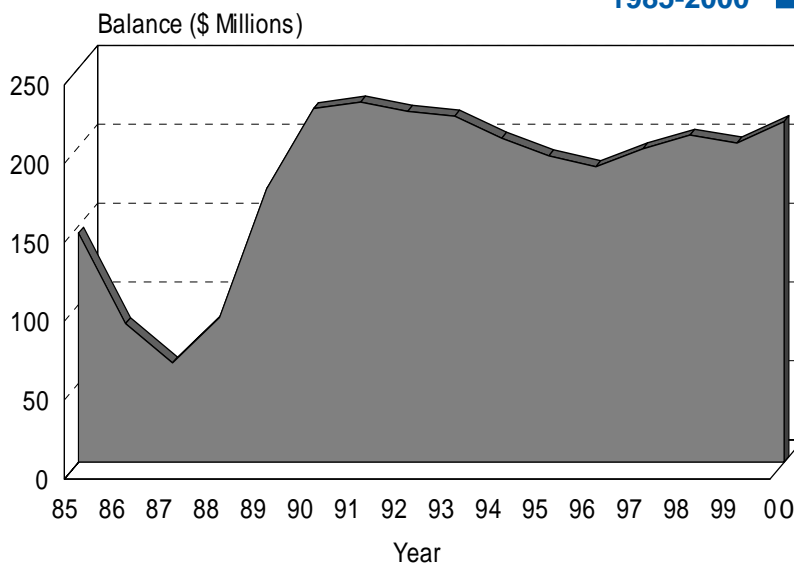
Unemployment compensation is an insurance program, not a social welfare program. As such, it must be self-supporting. This means that, in the long run, employer and employee contributions and reimbursements must be roughly equal to benefits paid out to claimants. Each state has its own financing system to achieve that goal by varying employer taxes, and in two cases, employee taxes. The only other state besides

Alaska that taxes employees each year in order to pay for part of benefit costs is New Jersey.

In early years, Alaska's system was based solely upon the "reserve multiple" (a system still used in many states), which varies tax rates according to a schedule based on the ratio of UI trust fund reserves to payroll. In 1980, state law transformed the unemployment insurance tax structure into a highly reliable, self-adjusting financial system based less upon trust fund reserves and more upon UI benefit costs. The tax base automatically adjusts to changes in average earnings, and the tax rate automatically adjusts to changes in benefit costs, payroll, and the trust fund reserve ratio.

## UI Trust Fund End-of-Year Balance

1985-2000



Source: Alaska Department of Labor and Workforce Development, Research and Analysis Section

## Benefit Costs and Benefit Cost Rate drive the UI system

The primary purpose of any financing system is to cover benefit costs. The cost of benefits is expressed as the ratio of the amount of benefits paid in the current year to the total payroll during the previous year. This ratio is called the benefit cost rate (BCR). The BCR is a measure of the potential funding needed to pay unemployment benefits, and the financial impact of unemployment benefits on the economy of the state.

The BCR for taxable employment was 2.0% in 1999, and averaged 2.1% for the 10-year period from 1990 to 1999. In general, the average benefit cost rate in Alaska is higher than in other states. This is attributable to two factors: the seasonality of much employment, and the fact that a larger proportion of the unemployed receives UI benefits in Alaska than in any other state.

Employers make payments to the UI system in two different ways. Employers are designated as either "taxable" or "reimbursable." As the term implies, taxable employers make quarterly tax payments, determined by their assigned tax rate, and the amount of taxable payroll. Reimbursable employers pay back the UI system for the amount of UI benefits paid to their former employees. Reimbursable employers are generally large organizations with stable workforces, such as state and municipal governments, but also include private non-profit organizations.

Benefit cost rates in reimbursable employment tend to be less than one-third the rate in taxable employment. The benefit cost rate in reimbursable employment was 0.5% in 1999, and averaged about 0.6% over the ten year period from 1990 to 1999. These low benefit cost rates result from the generally stable and non-seasonal employment practices of our major reimbursable employers, state and local government.

## The UI Trust Fund is a savings account for paying benefits

Each state has a trust fund for the sole purpose of paying unemployment insurance benefits. Withdrawals are made from reserves as needed to make payments to claimants. Taxes, reimbursements, interest, and other sources of contributions are deposited into the fund to build reserves.

Maintaining the solvency of the trust fund is one of the most important tasks of any UI system. Occasionally, a recession may be severe enough that money drawn from the fund to pay benefits exceeds revenues and reserves. If a state's fund becomes insolvent, the state may borrow from the federal government.

During the territorial era between 1955 and 1960, Alaska borrowed \$9 million from the federal government to keep its trust fund solvent. Annual benefit payments from 1952 through 1959 exceeded collections, breaking the fund temporarily in 1955 and then again in 1957. To replenish the fund, the amount of wages subject to taxes was increased, and taxes were levied on employees beginning in 1955. While many states borrowed to pay benefits in the early 1980s, Alaska has not borrowed to pay UI benefits since 1960.

The level of employment and payroll in the economy has a direct effect on the amount of benefits that will potentially need to be paid. Therefore, the ability of trust fund reserves to pay benefits during recessions cannot be measured simply by the level of reserves. A better measure is the reserve rate, which is the ratio of reserves to total wages subject to contributions. A trust fund reserve rate of approximately 3.2% of wages subject to contributions is generally considered adequate in Alaska.

The recession of 1986-87 had a serious impact on Alaska's UI trust fund, but reserves were adequate to maintain solvency. At the end of 1985, Alaska's

trust fund reserves were \$145.4 million, and the reserve rate was 3.3%. By 1987, trust fund reserves had fallen to \$63.0 million with a reserve rate of 1.7%. The fund reserve balance bottomed out in April 1988 at \$45.9 million. By the end of 1990, fund reserves had rebuilt to \$224.3 million, with a reserve rate of 4.8%. At the end of 1999, the reserve rate was 3.16%, quite close to where it has rested for the past three years.

### State taxes are principal income source for UI Trust Fund

State UI tax revenues collected from employers and employees are the principal source of income to the unemployment insurance trust fund. In 1999, tax contributions to the UI trust fund were \$105.2 million, 72% of total revenues. This marks a decrease in tax contributions from the previous year.

Employers are experiencing lower than average tax rates, and have been since 1991. For employers, the 2000 tax year marked the ninth year in a row when the average employer tax rate (2.14% of the taxable wage base in 2000) fell below the prior 10-year average.

State taxes are assessed on wages up to a set taxable wage base. The tax base is defined in AS 23.20.175(c) as 75% of the average annual earnings in covered employment for the immediately preceding year ending June 30. The state taxable wage base was \$24,800 in 2000, and is 25,500 for tax year 2001.

### Tax rates calculated on Benefit Cost Rate and Trust Fund Reserve Rate

Employer and employee taxes in Alaska have three essential components: the average benefit cost rate (ABCR), individual employer experience factors, and the trust fund solvency adjustment (TFSA). Tax rates are calculated in November and apply to the following calendar year. The formulas for calculating tax rates are as follows:

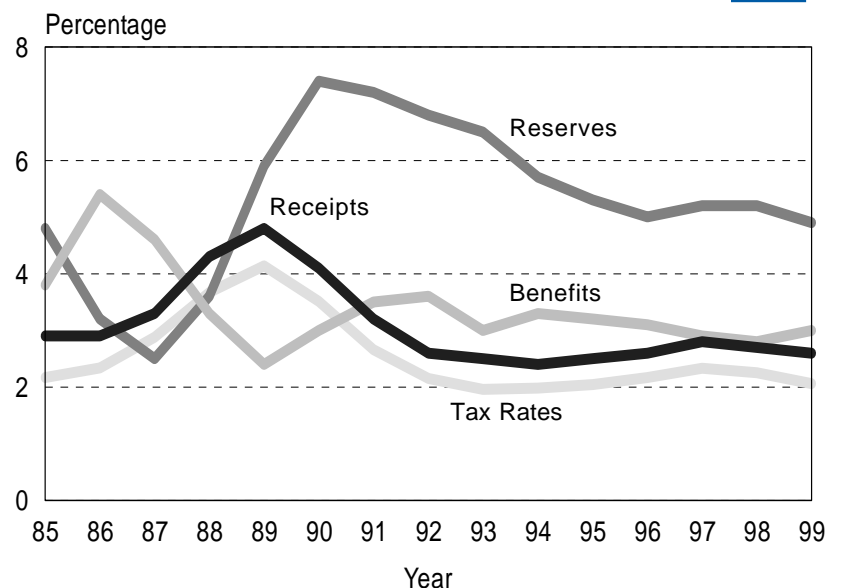
Employer tax rate = (.8 times the average benefit cost rate times the experience factor) plus the trust fund solvency adjustment

Employee tax rate = .2 times the average benefit cost rate

For tax rate calculation purposes, the average benefit cost rate (ABCR) is defined as the cost of benefits over the most recent three year period ending June 30, divided by the total payroll of contributing employers over the first three of the last four years ending June 30.

The ABCR measures benefit outlays which must be replaced by contributions. Basing the calculations on three-year periods makes the system “counter-cyclical.” This means that contribution rates increase slowly or even decrease during recessions as the trust fund is drawn down, then increase more rapidly during periods of economic stability or growth to replenish the fund. When the ABCR is low, or when the trust fund reserves are high relative to payroll, contribution rates decline and act as a stimulus to the economy.

## Reserves, Receipts, Benefits, and tax rates as % of taxable payroll **2**



Source: Alaska Department of Labor and Workforce Development, Research and Analysis Section

Prior to January 1, 1997, employers paid 82% of the ABCR, and employees paid 18%. Beginning in 1997, these rates shifted to 80% and 20%. Employee rates are the same for each employee. Employer rates vary according to the employer's individual experience with employee turnover and include a surtax to guarantee the solvency of the trust fund.

### Experience Rating varies individual employer taxes

An individual employer who lays off employees seasonally, or at a greater rate than other employers, will contribute more to unemployment and the payment of UI benefits. Experience rating systems have been established in each state in recognition that such employers should contribute more to the trust fund to cover the benefit costs of their former employees.

Three types of tax rates are assigned to employers. A-rated firms are those which have at least four quarters of wage history prior to June 30 of the year immediately preceding the tax year. A-rated firms qualify for experience rating. B-rated firms are those which have fewer than four quarters of wage history; they pay the standard industry tax rate. C-rated firms are those which fail to report on a timely basis or are delinquent in their payments; they are taxed at the maximum rate, which can be no less than 5.4%. In 2000, 86.7% of all contributing firms were A-rated; 11.5% were B-rated; and 1.8% were C-rated.

Alaska is the only state that uses the payroll decline quotient method of experience rating. The logic behind Alaska's payroll decline system is this: employers whose payrolls decline markedly are likely responsible for more compensable unemployment than are employers whose payrolls decline little. Therefore, follows the logic, they should contribute more to cover the higher benefit costs of their former employees.

Under the payroll decline system, each employer's percentage decline in payroll from one quarter

to the next is averaged for the prior four to 12 quarters. The resulting decline quotients of all employers are then arrayed in ascending order and divided into 21 rate classes. Employers are assigned to the rate classes so that 5% of the total statewide payroll is accounted for in each class, except for the 20<sup>th</sup> and 21<sup>st</sup> rate classes, which account for 4.99% and 0.01% respectively. (The 21<sup>st</sup> rate class was added in 1984 in response to federal legislation requiring a standard tax rate of 5.4% from which the state could reduce tax rates in accordance with experience.) Experience factors are assigned to each rate class—the higher the rate class the greater the experience factor. Experience factors range from 0.4 to 1.65, according to a schedule in AS 23.20.290(c).

Methods of experience rating used in other states are the reserve ratio system (30 states, and Washington DC, Puerto Rico, and the Virgin Islands), the benefit ratio system (17 states), and the benefit-wage ratio system (two states). All of these systems use actual benefit payments, or approximations of benefit payments, as the basis for experience rating—they are called "chargeback" systems. In contrast, the payroll decline quotient system considers only changes in payroll as an approximation of benefit charges, without considering actual benefit payments.

Alaska's payroll decline quotient system has worked well. The system withstood the tremendous shock of the 1986-87 recession, and fully recovered by the end of 1989. The ratio of benefits paid to contributions paid averages around 1.0 for most industries in Alaska, so although there may be individual employers with problems, industry-wide the system functions well.

Without a doubt, "chargeback" systems are more complex and expensive to administer than the payroll decline quotient system. This is due to the constant policy decisions about individual employer responsibility for charges, the types of benefits to exempt from charging, and the increased staffing needed for the higher level of employer contact prevalent in the administration of "chargeback" systems.

In the end, the simple fact is that employer and employee taxes cover benefit payments. This is true of any state's system. If benefit costs are higher in Alaska than in other states, taxes will be higher. If a state wants to reduce employer taxes, then benefits must be reduced.

### The Trust Fund Solvency Adjustment is a uniform tax surcharge

In order to provide benefits during recessions, the trust fund reserve balance must be maintained at a sufficient level. Benefit cost rates are not always adequate to do this. Therefore, a surcharge is added to employers' tax rates if the trust fund reserve rate falls below 3.0%. A credit is provided to reduce employers' tax rates if the reserve rate equals or exceeds 3.3%. The trust fund solvency adjustment (TFSA) is applied uniformly to all employers at a rate between minus 0.4% to plus 1.1%, depending on the trust fund reserve rate, according to a schedule in AS 23.20.290(f). The TFSA may be increased or decreased by only 0.3%, or less, from one year to the next. The TFSA was 0.3% in 1987, 0.6% in 1988, and 0.9% in 1989. In 1996, the TFSA was minus 0.2%, and in 2000 and 2001 there were no adjustments.

### Federal taxes fund UI program administration

Besides state unemployment taxes, employers also pay taxes to the federal government to cover administrative costs. In 1985, these FUTA (Federal Unemployment Tax Act) taxes were raised to 6.2% of payroll up to a base of \$7,000. However, as long as state law conforms to federal law, employers receive a credit of 5.4% against their FUTA taxes, making the effective tax rate 0.8%. This is \$56 for each employee earning \$7,000 or more annually. In federal fiscal year 1999, the federal government estimated employers in Alaska contributed \$13.1 million in FUTA tax revenues. More recent information has been difficult to obtain.

The FUTA credit is a powerful incentive to keep state programs within federal limits. Conformity

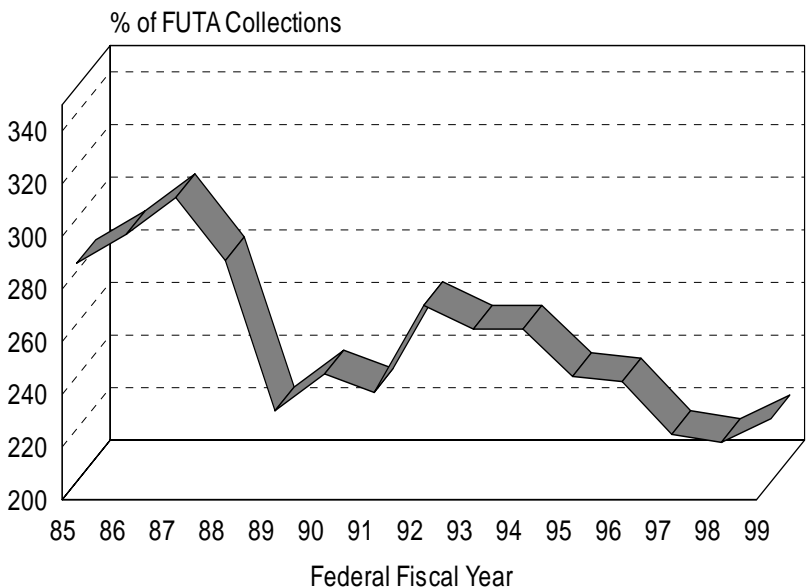
to federal law is frequently the reason for adopting new state provisions. Alaska's Employment Security Act currently conforms to federal law. There have been no recent changes in federal law that would require state conformity legislation.

The federal government pays for administration of the state's unemployment program through administrative grants. A portion of FUTA collections, which are kept in a federal account and not in the state trust fund, funds the grants. In federal fiscal year 1999, Alaska received \$29.4 million in administrative grants (\$20.0 million for unemployment insurance administrative costs and \$9.4 million for employment services). In federal fiscal year 1999, Alaska's total administrative grants amounted to 224% of state FUTA contributions, a good bargain for workers and employers in the state.

### Direct reimbursements supplement employer tax contributions

Regular benefits, extended benefits, and supplemental state benefits are all disbursed

## Federal Administrative Grants 3 As a percent of FUTA collections



Source: Department of Labor and Workforce Development, Research and Analysis Section

through the state trust fund, even though these programs differ in the way they are financed. As mentioned earlier, the major source of revenues deposited into the fund is employer taxes. But revenues also come from a variety of other sources.

The federal government reimburses the trust fund for 100% of regular and extended benefits paid to former federal employees (UCFE) and former military employees (UCX), as well as a portion (about 50%) of all non-federal extended benefit (EB) payments. In 1998 and 1999, the federal government reimbursed over \$15.8 million (not including interest) to Alaska's trust fund. The federal share of EB funds amounted to about \$5.5 million.

Nonprofit organizations and state and local government agencies which choose to reimburse the trust fund directly (instead of paying tax contributions) reimburse 100% of the regular UI benefits and EB paid to their former employees. Through 1988, nonprofit agencies reimbursed only half of EB. In 1989, however, the legislature changed the law. In 1999, reimbursable employers reimbursed \$10.3 million to the UI trust fund.

### Some parts of the UI system subsidize other parts

UI claimants occasionally receive more in benefits than their employer contributed in taxes. The benefits paid to the claimant are subsidized by other employers. The flow of funds is never perfect in any UI system, and every type of experience rating system has problems with subsidies. Some categories of employers tend to be subsidized more than others.

One form of subsidy occurs across years. One way to measure the equity of the system is to measure the ratio of benefits paid in one year to the contribution paid in the prior year. In the years surrounding the recession (1985-87) the

benefit/contribution ratio exceeded 1.0, meaning that benefits paid out in those years were more than tax revenues in the immediately preceding years. During this time, the difference was being made up by trust fund reserves. Employers in prior years were subsidizing employers during the recession years. Starting in 1988, and continuing through 1991, the ratio declined to less than 1.0, as employers subsidized employers in future recessions. In 1992 the ratio increased to 1.1, a reflection of the fact that the trust fund administrators attempted to reduce the level of reserves. This trend held through 1997. In 1998, the ratio of benefits to prior year contributions fell to 0.9, and, in 1999, returned to 1.1.

One of the most important subsidy categories is the cross-industry subsidy. Although cross-industry subsidies occur under all economic conditions, the expression of the subsidies is better seen during years when Alaska is experiencing relatively stable economic conditions. Under good economic conditions (1981 to 1985, for example), some industries have historically had ratios higher than 1.0. These industries with higher ratios also tend to have higher benefit cost rates than other industries.

Over the past 10 years within taxable employment, the industries most subsidized, in order, are: paper products (with a ratio of 3.34), construction (1.35), taxable public administration (1.34), food products (1.25), lumber and wood (1.23), and other mining (1.12). On the other hand, the industries which normally pay more than their fair share in contributions are transportation, communications and utilities (0.75), oil and gas (0.83), trade (0.84), finance, insurance and real estate (0.87), and agriculture, forestry and fish (0.93).

The industries that are historically the most subsidized in Alaska also have some of the most seasonal employment patterns. The subsidies are partly a reflection of the highly seasonal nature of Alaska's economy. Even after being subsidized,

firms in these industries historically pay the highest tax rates in Alaska. The payroll decline system attempts to recover benefit costs by taxing high-cost employers at higher rates.

## Measuring benefit adequacy

Policy makers have to look at the question of what benefit amount is appropriate. Universally, all states determine a worker's benefit amount with a formula based on the individual worker's earnings. Many states build the benefit amount on the highest quarter earnings in the qualifying period, while others look at wages over a longer four-quarter term. Each state has a mechanism for setting the minimum and maximum benefit amount as well.

The ideal replacement has long been held to be 50% of wages. Because of the differences in state systems, good comparisons between the states can be a challenge. No publication seems complete without the expected discourse on how the structure of the Alaska economy differs from even its closest geographic neighbors. The measures readily available have to be viewed with some understanding that the unique characteristics of Alaska are not captured in these statistical yardsticks.

There are several ways of looking at benefit adequacy. One measure is a replacement rate developed by the federal Unemployment Insurance Services that is used to evaluate the performance of state systems. In federal fiscal year 1999 data, the US average wage replacement rate was 46%, with 34 states (and DC) above the average and 18 states below. Alaska's replacement rate was calculated to be 32%, placing it last among states. Conversely, Alaska ranked first among all states in reciprocity, a federal measure of the share of the unemployed workforce served by the state's UI system.

A second very similar measure is the percent of wage replacement, a simple relationship between

the average benefit amount paid during a year, and the average statewide wage. Alaska has a high average weekly wage (\$640, ranked fourteenth nationally in 1999). Alaska's average benefit amount in 1999 (\$182) was in 41<sup>st</sup> place in the ranking of states. These data result in a replacement rate of 28.4%, which, when measured against a national average of 33.4%, places Alaska 47<sup>th</sup> nationally. (See *Unemployment Insurance Actuarial Study and Financial Handbook, 1999*).

A third and last way of looking at benefit adequacy, distinctly different from the prior two, is to examine the maximum weekly benefit amount (MWBA). In 1999 the MWBA among states ranged from a high of \$477 (Massachusetts) to a low of \$190 (Mississippi). Alaska's MWBA is \$248, placing it in 45<sup>th</sup> place among states. Our nearest neighbor state, Washington, has both high wages (\$684, ninth highest in 1999) and a high MWBA (\$441, second highest in 1999). Washington's economy is mature, with stable and low unemployment rates, and its population is well over six million. (It is appropriate to note that Washington raised its MWBA to \$478 in 2000.) Economic comparisons between Alaska and Washington are commonly made. If Alaska used Washington's benefit calculation formula with Alaska's average wage, we would have a maximum weekly benefit amount of \$444, a benefit structure the current tax base could not support.

In the end, the topic of benefit adequacy must be discussed in context of the financing system that supports it. Or more simply, what level of benefit adequacy can we afford, given the special nature of the Alaska economy? Because the Alaska economy is changing over time, issues of financing and benefit adequacy will always be under review.