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# SERVICE BULLETIN

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## Commentary on Unemployment Taxes

April 2, 2010

Regardless of your industry or your company's financial condition, your state unemployment tax rates are higher this year. We have all seen the news about the loss of jobs during the last twenty-four months, resulting in an abnormal number of unemployment claims being filed. Further, the duration of claims has increased because of the difficulty in finding new jobs. The state unemployment trust funds have literally been tipped on their sides and drained of their contents. Inevitably, the funds must be restored, and this is accomplished by raising UI tax rates and UI taxable wage bases. But the question arises as to why there has been such a sudden and dramatic increase in UI taxes for 2010.

To understand what has happened to UI tax rates in 2010 it is helpful to revisit 1980. The country slipped into a recession that year, came out of it, and then slipped back into a deeper and longer recession in 1981. Many jobs were lost and the first major systemic problem for the unemployment insurance program was upon us.

During this time I found myself toiling away in the drafty old Cordell Hull Building in Nashville, putting together a legislative proposal to shore up the Tennessee Unemployment Trust Fund, which was rapidly becoming depleted. Tennessee was not alone. By the end of 1981, seventeen states had borrowed federal funds totaling more than \$6 billion because their trust funds were broke.

Spurred by this crisis, the U.S. Department of Labor, which provides support to the state unemployment agencies, became active during the early 1980's in helping these agencies determine an adequate solvency level. The goal was to maintain adequate reserves to cover benefit payouts and also provide a cushion for when the benefit payouts were higher than normal. This would be accomplished by refining the assignment of UI tax rates so that a funding shortfall as in 1980/81 would never occur again. A test was developed for assessing the solvency of a state trust fund, called the "High Cost Multiple," and many states attempted to incorporate this solvency measure, or something similar, into their tax scheme.

In the 1990's, the High Cost Multiple was modified and the recommended solvency measure became the Average High Cost Multiple. Ideally, the Average High Cost Multiple should have a value of 1.00 in "normal" times. A state law could incorporate automatic triggers to increase or decrease employer tax rates, depending on the divergence from the recommended solvency level. The U.S. Department of Labor tracked this statistic (and still does) and made it available to all state agencies.

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With the passage of time, this tool became disregarded. Political motivation entered into decisions to reduce UI tax rates in several states, and to provide for zero percent tax rates in some cases. California (roughly 20% of the U.S. economy) enacted legislation to increase the maximum weekly benefit amount by \$100, without any corresponding increase in taxes. California now has an outstanding UI loan of approximately \$8 billion.

By the end of 2007 the Average High Cost Multiple for all states combined was 0.52%; substantially below the recommended solvency level. Of course each state law is different, and some states were more solvent than others. However, no alarm bells were sounding. In aggregate, UI tax rate assignments drifted even lower for 2008. The average tax rate (as a percent of taxable wages) decreased from 2.48% in 2007 to 2.32% for 2008. As a percent of total wages, the average tax rate decreased from 0.69% to 0.63%. The increased sophistication of tax rate assignments, prompted by the 1980/81 solvency issues, had become inadequate.

In early 2008 the Texas Workforce Commission informed Texas employers that for the second year in a row they would be giving back funds to employers (\$170 million that year) because the balance in the Texas Unemployment Trust Fund exceeded the statutory ceiling. That was just about the end of the good news. By June the loss of jobs had picked up pace, resulting in President Bush signing H.R. 2642, which established the Emergency Unemployment Compensation Program for individuals who had exhausted their regular unemployment benefits.

Interestingly, UI tax rates did not trend higher for 2009 even though the recession was in full swing as the year began. Clearly the state trust funds had been drawn down at a rapid pace in 2008. Cumulative trust fund balances dropped from \$38 billion at the end of 2007 to \$30 billion at the end of 2008. Over \$12 billion in regular benefits were paid in the fourth quarter of 2008 alone, compared to \$7.9 billion for the fourth quarter of 2007. The Michigan trust fund was already borrowing federal funds by the end of 2008. Nevertheless, the average UI tax rate drifted still lower for 2009 (2.25% of taxable wages and 0.60% of total wages).

The ship had hit the iceberg in 2008, but UI tax rates were largely unaffected until 2010. Of necessity, there was a lag between the onset of high benefit payouts and increases in tax rates. Most (36) states use a computation date of June 30 to compute UI tax rates for the following calendar year. An employer's experience as of June 30 is used for computing the UI tax rates that take effect six months later. During the six-month period from July through December of 2008 the loss of jobs was substantial and the payout of UI benefits was abnormally high, but this had little or no impact on 2009 tax rates in many states because the computation date had passed. Of course, these post-June 30, 2008 claims are now included in 2010 tax rate calculations.

The increase in UI tax rates for 2010 has been sudden and dramatic. According to a survey by the National Association of State Workforce Agencies, the median projected increase in UI tax revenue for 2010 is 27.5%. Ominously, several of the states with the largest trust fund loans have yet to increase rates significantly, increasing the likelihood of rate increases for 2011. These states include California, Michigan, Illinois, Indiana, Ohio, North Carolina, and New York. We expect UI tax rates to remain elevated for three or more years.

As a result of disregarding the Average High Cost Multiple, there has been a lack of counter-cyclical financing and employers are now feeling the effects of this policy. If the state trust funds had average high cost multiples of 1.00 going into this recession, there would now be eight states with federal loans totaling about \$3 billion. As it stands, there are now thirty-two states and the Virgin Islands with outstanding federal loans of \$37 billion. One could argue that employers have had the use of their money longer, having contributed less to the trust funds until this year, and that counter-cyclical financing is not necessarily desirable. However, in the midst of a recession, some employers have now gone out of business, so the higher taxes are collected only from the survivors.

Another contributing factor to the decline in trust fund solvency has been the gradual decline in the proportion of wages that are taxed. Chart #1 (attached) illustrates that the ratio of taxable wages to total wages has dropped continuously over the years, despite the fact that some state taxable wage limits increase each year. By contrast, benefit payouts are holding relatively constant as a percent of wages (see Chart #2). We expect that the taxable wage limits will receive increased attention now, and that significantly higher SUI taxable wage limits are on the horizon.

Going forward, more UI benefits will be payable because of the expansion of eligibility, and these benefits will be funded by future UI taxes. Provisions in the Recovery Act encouraged states to enlarge the pool of workers who are eligible for UI benefits, and many state UI laws have been amended. Many states now approve UI claims for individuals who limit their availability to part-time work only. Many disqualifications have been removed from state UI laws, relating to individuals who quit for certain non-work related reasons. For these reasons, we doubt that the ratio of UI taxes to total wages will ever return to the 2009 level.

It has now become more important than ever to control this cost. We can and will collectively ensure that your tax accounts are not charged for unwarranted or improper claims. We will also continue to monitor your tax rates to ensure that they are correct and as low as possible, given your experience. Finally, it continues to be important to educate front-line managers as to their roll in controlling this cost, and we are glad to assist with this as well.

As always, if there are any questions please contact us.

