

UI Tax Structure – Smarter Taxes

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Unemployment Insurance (UI) Trust Funds are bottoming out nationwide. In the melee of policy debates to fix the situation, many issues will be discussed, such as: whether to borrow from the federal coffers; whether to implement automatic rate adjustments; and whether proposed rate changes will be enough. However, as with all policy debates, especially urgent ones, smart policy can easily be missed.



State UI tax systems can promote or discourage employment, and in a time of record unemployment, policy makers should carefully consider the impact of their state UI tax structure to job unemployment. For example, according to economists, state UI tax system inefficiencies and unfairness are responsible for between 20-50% of all temporary layoffs in the US, depending on the state of the economy.

If you get in a car accident, you can bet your rates are going up. But, if a company has heavy usage of the UI system, it does not always translate into a proportionate increase in UI tax rates. This is due largely to the socialized costs that are hidden in many states' tax structures. In the end, the UI tax discourages employment not only by being a tax on employment, but also, in many states, by foisting much of the cost of over-users of the system onto the backs of those who are not making layoffs. Such inefficiencies in state UI tax systems can stifle the creation of jobs and create competitive disadvantages among employers.

What weaknesses make a UI tax system inefficient and cost states jobs? Many factors are at play, but we will examine three basic responsiveness problems here: 1) low tax caps, 2) high tax floors and 3) large cliffs between tax rates.

Tax Caps

Capping the top tax rate a high layoff employer must pay is often the most unfair part of the UI tax structures. Some employers use the system hundreds of times more than other employers do. In many states, however, high users' rates are capped at just five times the lowest rate. At the start of 2009, seventeen states did the bare minimum

allowed by federal law, setting their tax cap 5.4%. By comparison, fourteen states used their discretion to make their rates more responsive and had a cap of 9.0% or greater. Examples top rates in the more responsive systems were: Massachusetts at 12.27%; Michigan at 11.05%; and Arkansas at 10.8%.

As states raise rates to respond to trust fund shortfalls, they should raise their tax caps as well to more fairly apportion taxes to employers based on their use of the system. Doing so will also realign employer incentives to avoid convenience layoffs and employer use of the state system as a low cost severance package funded by other employers.

Tax Floors

Many states have a bottom rate they charge all firms, even those who have never made a layoff. In many states, a company could have gone 50 years without making a layoff and still have to pay 1% (or more) to fund the costs of other employers whose business models use the system more extensively. However, nine states disagree with this policy and have a 0% bottom rate. By doing so, they rightly reward companies that keep their employees employed.

A second best alternative to providing a 0% bottom rate is to take the minimum tax and put it in a separate pot from the experience-rated portion of employers' tax rates to make it easy to quantify and understand the welfare-like part of the state's unemployment tax. An example is Texas, where socialized costs are at least transparent and in a separate fund.

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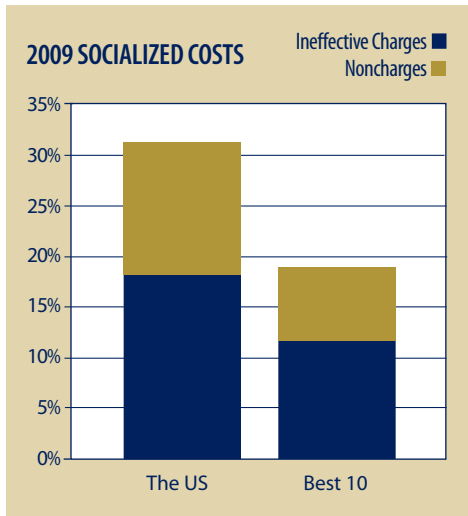


Table 1: 2009 Average State Socialized Cost Comparison

The United States' average UI tax structure had 64% more socialized costs than the Best 10 states, costing all employers \$9.5 billion annually for such charges.

| Best 5 States | Best 10 States | United States |
|---------------|----------------|---------------|
| xx% | xx% | xx% |

(Data from the 2008 Significant Measures Report)

The percentage of benefit costs not charged to responsible employers, but instead socialized as:

- 1) Noncharges – the total amount of benefit payments not charged to individual employer experience rating accounts. They often shift to the UI tax system social program costs; such as payments to workers who voluntarily quit and
- 2) Ineffective Charges – the yearly amount of benefit charges assigned to individual employers that exceed the amount of contributions paid by those same employers in the following year. These charges tend to lessen some employers' responsibility to pay the full cost of their claims, due to e.g. a maximum tax rate that is too low or an otherwise less responsive tax structure.

The levels of both noncharges and ineffective charges are largely within the control of state policy makers and affect the state's unemployment rates by raising or lowering: 1) the cost of employing a worker and 2) the cost of laying off a worker.

Tax Cliffs

Another nonresponsive and inefficient part of many state tax systems is the "cliffs" that exist between tax rate levels. In many states, employers must make many layoffs in some situations

before their rate will climb the cliff upwards to adjust for their heavy use of the system. The result is a poor incentive to manage layoffs. For example State A with five rate schedules and a 1.5% range between rates is much less responsive to providing an equitable experience-based tax than State B with 15 schedules and a 0.25% range between rates.

This works in the opposite direction as well, where employers who had one bad year of layoffs have a very difficult time lowering their rates in the future and often decide unemployment is a sunk cost to ignore.

Historically, there was some reason for this problem. The UI system was born in 1935, back in the days of the abacus and when "working on an Apple" meant eating fruit. Logistically, it was difficult to manage many different points along a rate schedule. The more points, the more paperwork and the more difficult it was for states to calculate, apply and collect taxes on employers at numerous tax rates.

Today, the reason for large tax rate cliffs is gone. Our highly-automated and computer-driven tax programs can just as easily generate tax calculations to the nth decimal point as the stock market can immediately respond to an earnings report.

Experience-rated systems can and should charge employers rates that more properly reflect their experience within the UI system.

Other Factors

Other ways in which state systems undermine job growth and create tax unfairness are beyond the scope of this paper, but are worth noting. For example, there is an increasing tendency for states to "non-charge" employers for certain types of claims and socialize the costs to all employers, such as when an employee quits a job to relocate with a spouse. Another example is erroneously-paid benefit claims (overpayments generally average 10% nationwide) and uncollected taxes, which can negatively affect the adequacy of trust funds. These and other issues can, at times, be complex, but solvable.

While a number of states have developed responsive and smart UI tax systems, the majority do not. Above in Table 1,

you can see how the socialized costs in the average state compare to the ten best states. To find your state's performance, go to www.fullemployment.org.

Summary

States have an historic opportunity to rationalize their UI systems and reduce the negative effects they have on employment. They can do so by: 1) raising the top tax rates to 10% or more as they raise other rates, 2) lowering tax floors to 0% to incentivize all employers to promote employment and 3) significantly reducing the cliffs in tax rates to allow a smooth system that responds to layoffs in the near term rather than over a protracted number of years. By doing so, states can take a proactive role in reducing the unemployment caused by many state tax systems.

¹A study by University of Chicago economist Robert H. Topel focused on temporary layoffs rather than permanent job terminations. He found that "... incomplete experience rating may account for as much as 30 percent of all spells of temporary layoff unemployment." "On Layoffs and Unemployment Insurance," *American Economic Review* (vol. 73, September 1983), pp. 541-559.

Drilling down to the depths of recessions, the well known economists David Card and Phillip Levine found that 50% of temporary layoffs were caused by poor experience rating, with much smaller effects during business expansion. "Unemployment Insurance Taxes and the Cyclical and Seasonal Properties of Unemployment," *Journal of Public Economics*, v. 53(1), January 1994, pp. 1-29.