Unemployment Insurance Taxes

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Economists

A cushion for the unemployed, a stabilizer for the economy

The unemployment insurance system created by the U.S. government nearly 70 years ago is designed to help stabilize the economy. It is a self-financed system, which each state administers according to its own laws. Benefits, financed by employer and employee taxes, are infused back into the economy to strengthen the business climate, to provide some relief to individuals, and to stabilize the workforce needed by employers. This article focuses mainly on the financing side, specifically the computation of taxes.

Unemployment Insurance (UI) provides a benefit to the economy, as well as to individuals. Taxes levied on employers and employees pay for benefits. To oversimplify, it is the cost of benefits that have been paid out that determines what next year's taxes will be.

The benefit to the Alaska economy

Individuals who are temporarily out of work get a partial replacement of their wage that is used to purchase the basics of a living. These dollars are returned to the economy and help enhance the business climate, especially in smaller communities. If UI benefits were not available, workers might have to relocate, and would later not be available for work in the local labor market. It is desirable for businesses to have a pool of experienced workers available when needed, particularly in a place like Alaska with its highly seasonal economy.

Exhibit 1 shows the economic input to local economies in Alaska from the UI system. It shows the amount of benefit dollars paid to individuals in each of the state's census areas. It also shows the totals paid from the Alaska UI program over the last ten years. During 2003, $141 million dollars was paid to claimants in Alaska's 27 census areas. The largest portions went to the state's more populous areas, but significant amounts were dispersed in all parts of the state.

Basic concepts of the UI tax system

Taxes pay for benefits: The UI tax monies that are collected from Alaska employers and workers are used to pay for benefits. The administrative cost of the Alaska UI program is paid for by an administrative grant from the U.S. Department of Labor, from funds generated by the Federal Unemployment Tax Act system. The UI tax money ends up back in the economy. (See side bar page 20 about portion of employee tax used for STEP and TVEP worker training programs.)

The UI Trust Fund: The UI taxes collected are deposited into a trust fund, which is in the custody of the U.S. Treasury. Monies for payment of benefits are withdrawn on an "as-needed" basis. The trust fund's interest earnings are also used for benefit payments. The trust fund has two basic purposes. The first is to hold tax money and earnings for the payment of benefits. The second is to hold the trust reserve, an amount sufficient to maintain the solvency of the UI system through the demands of a long and deep recession.

Counter-Cyclical Financing: This is a critical principle of the UI system. The system is designed so that the reserve fund is capable of paying for benefits during a period of severe demand (recession). During such a time the level of the reserve will be reduced. Under counter-cyclical

(continued on page 19)

1 Amount of UI Benefit Payments
By census area 2003

Areas	State UI 1/ Regular	State UI 1/ Extended Benefits	UCFE 2/ Regular	UCFE 2/ Extended Benefits	UCX 3/ Regular	UCX 3/ Extended Benefits	TEUC	SSB 4/	All Programs Total
Aleutians East Borough	$332,594	$55,236	$0	$0	$0	$0	$29,973	$0	$ 417,803
Aleutians West CA	814,215	89,477	6,832	0	0	0	65,105	300	975,929
Anchorage Municipality	34,289,497	4,894,723	528,092	83,679	402,924	45,109	5,581,540	50,602	45,876,166
Bethel Census Area	3,247,152	640,134	10,642	1,810	9,786	3,056	637,634	38,926	4,589,140
Bristol Bay Borough	189,046	36,465	3,621	0	0	0	30,875	830	260,837
Denali Borough	557,637	108,862	76,795	12,866	0	0	45,775	301	802,236
Dillingham Census Area	735,377	138,504	0	0	0	0	162,182	5,901	1,041,964
Fairbanks North Star Borough	11,455,462	1,622,517	384,534	30,516	249,333	23,964	1,377,142	21,190	5,164,658
Haines Borough	575,501	120,160	8,279	1,177	6,104	0	70,438	1,904	783,563
Juneau Borough	3,881,521	474,226	55,283	2,919	9,909	0	605,839	5,910	5,035,607
Kenai Peninsula Borough	10,837,715	1,984,692	123,418	21,431	26,055	0	1,636,869	23,054	14,653,234
Ketchikan Gateway Borough	2,358,613	425,208	14,576	1,968	37,237	3,330	388,012	12,142	3,241,086
Kodiak Island Borough	3,152,022	291,493	14,127	0	13,845	2,684	151,512	3,052	3,628,735
Lake & Peninsula Borough	295,915	37,057	5,400	2,229	0	0	32,844	2,097	375,542
Matanuska-Susitna Borough	12,666,573	2,113,996	160,351	20,664	51,792	7,413	1,981,270	30,156	17,032,215
Nome Census Area	1,640,950	295,686	12,856	904	1,804	0	322,765	11,365	2,286,330
North Slope Borough	1,639,874	310,987	510	1,530	1,784	0	453,646	6,886	2,415,217
Northwest Arctic Borough	1,707,793	426,036	13,621	3,575	4,014	0	578,514	11,550	2,745,103
Prince of Wales-Outer Ketchikan	1,514,086	258,432	2,216	944	16,937	6,989	217,818	4,589	2,022,011
Sitka Borough	1,171,065	129,163	21,561	320	5,977	0	122,193	2,112	1,452,391
Skagway-Hoonah-Angoon CA	908,940	156,305	18,159	6,267	1,784	0	78,302	1,633	1,171,390
Southeast Fairbanks Census Area	1,270,189	249,070	42,136	6,119	8,984	0	197,598	3,629	1,777,725
Valdez - Cordova Census Area	2,306,718	481,457	61,893	21,454	0	0	376,181	10,923	3,258,626
Wade Hampton Census Area	1,927,179	414,188	150	0	2,230	2,701	392,730	24,923	2,764,101
Wrangell - Petersburg CA	1,637,584	260,462	14,506	0	0	0	182,313	6,243	2,101,108
Yakutat Borough	200,179	30,864	0	0	9,846	0	16,592	0	257,481
Yukon - Koyukuk Census Area	1,514,279	387,263	22,880	6,938	3,900	0	336,609	6,655	2,278,524
Area Unknown	2,428,350	516,987	35,691	4,820	8,192	7,554	452,843	12,037	3,466,474
In-State Totals	105,256,026	16,949,650	1,638,129	232,130	872,437	102,800	16,488,956	298,910	141,839,038
Interstate Totals	22,704,677	2,155,639	820,097	48,509	97,643	10,495	7,190,436	11,763	33,039,259
Totals All Areas	127,960,703	19,105,289	2,458,226	280,639	970,080	113,295	23,715,550	310,673	174,914,455

Ten-Year Historical Data Series for Census Area Totals

Year	State UI 1/ Regular	State UI 1/ Extended Benefits	UCFE 2/ Regular	UCFE 2/ Extended Benefits	UCX 3/ Regular	UCX 3/ Extended Benefits	EUC/TEUC	SSB 4/	All Programs Total
1994	$117,904,643	$14,895,807	$4,536,264	$449,480	$1,280,696	$144,639	$10,494,385	$304,145	$150,010,059
1995	113,609,324	7,248,703	4,343,639	202,109	1,199,348	57,836	46,043	136,008	126,843,010
1996	114,031,840	6,906,444	3,342,795	186,912	883,029	49,526	15,994	137,013	125,553,553
1997	108,885,202	5,438,470	2,911,603	115,401	998,659	34,166	0	90,726	118,474,227
1998	109,037,747	5,478,978	3,243,112	115,178	962,573	39,421	0	119,680	118,996,689
1999	117,903,392	6,842,307	2,992,843	172,629	1,129,943	56,767	0	136,217	129,234,098
2000	105,694,293	4,721,726	2,681,902	87,153	986,447	44,851	0	115,354	114,331,726
2001	109,267,895	4,507,552	2,516,390	108,500	967,571	40,899	0	106,195	117,515,002
2002	120,352,390	9,941,415	2,389,643	194,986	900,034	44,535	21,226,533	161,904	155,211,440
2003	127,960,703	19,105,289	2,458,226	280,639	970,080	113,295	23,715,550	310,673	174,914,455

1/ UI and UI-Combined (includes federal portion of UI-Combined).
2/Unemployment Compensation for Federal Employees
3/Unemployment Compensation for ex-servicemen
4/State Supplemental Benefits
* The Emergency Unemployment Compensation (EUC) program expired on April 30, 1994.
* The Temporary Emergency Unemployment Compensation (TEUC) program was effective March, 2002 through April, 2004.

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

financing, reserves are rebuilt after an economic downturn is over and the economy is in a recovery phase. It would be a bad idea to raise taxes during a recession. Adequate reserves, built during periods of relative prosperity, are counter-cyclical financing's way of buffering sudden rises in tax rates, and keeping tax rates as low as possible.

Experience Rating: All states have a system of assigning UI tax rates to employers that in some manner measures employers' impact on the finances of the UI system. The result is that employers with a costlier experience will receive higher than average tax rates, while those with less costly experience will get lower than average tax rates. Alaska's experience rating system defines 20 rate classes to which all employers are assigned.

Employee Taxes: Alaska is one of just three states that require workers to share the tax burden of the UI system. Alaska workers covered by the program all pay the same UI tax rates. Overall, employees pay 20 percent of the cost and employers pay 80 percent.

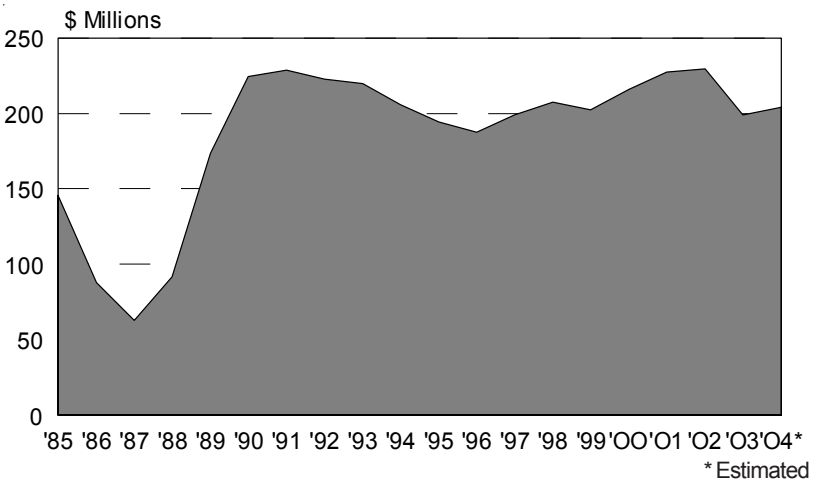
Alaska has a self-adjusting financing system

Every state has its own UI financing system, defined under its state law. These systems are varied, and attempting to compare the states can be a complex challenge. In some states the tax base is fixed, as are the tax rates, and adjustments may come slowly, sometimes too slowly to avoid insolvency. In the mid-1980s many states' UI trust funds went bankrupt, and they had to borrow and pay interest to the federal government to rebuild their systems. Alaska is fortunate to have a self-adjusting system that responds to its economic conditions, so that its fund will remain solvent. Currently a number of states have UI trust fund solvency concerns, while Alaska's fund is healthy. (See Exhibit 2.) Maintaining solvency through a self-adjusting system allows Alaska to have stability and relatively low tax rates over the long run, while avoiding the burdensome costs of rebuilding a fund.

Taxable wage base

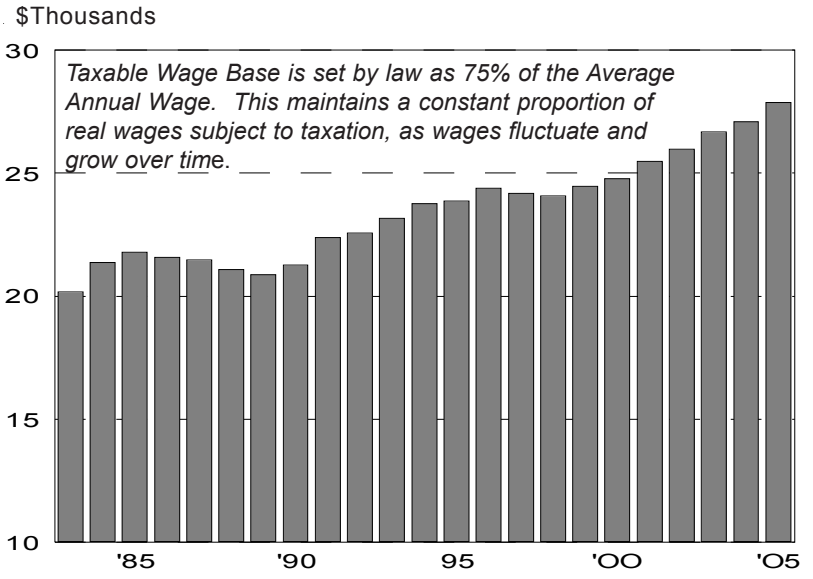
The amount of an employee's wages subject to taxation is called the taxable wage base. Wages earned in excess of the wage base are not taxed. The taxable wage base changes each year. Over time, Alaska's economy grows. The population increases, more businesses are started while others expand, and jobs are created. Wages tend to grow along with other components of the economy. Alaska's taxable wage base for the UI program is defined in law as 75 percent of the state's average wage. Allowing the taxable wage base to adjust each year ensures that the "tax rates" continue to cover the same proportion of real wages in the economy. If the wage base were unchanging, the tax rates would eventually become inadequate to maintain program solvency, and the system would attempt to correct itself with the "Trust Fund Solvency Adjustment"

End-of-Year Balance 2
Alaska UI Trust Fund 1985-2004



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

Alaska UI Taxable Wage Base 3
Keeps pace with wages in the economy



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

STEP and TVEP

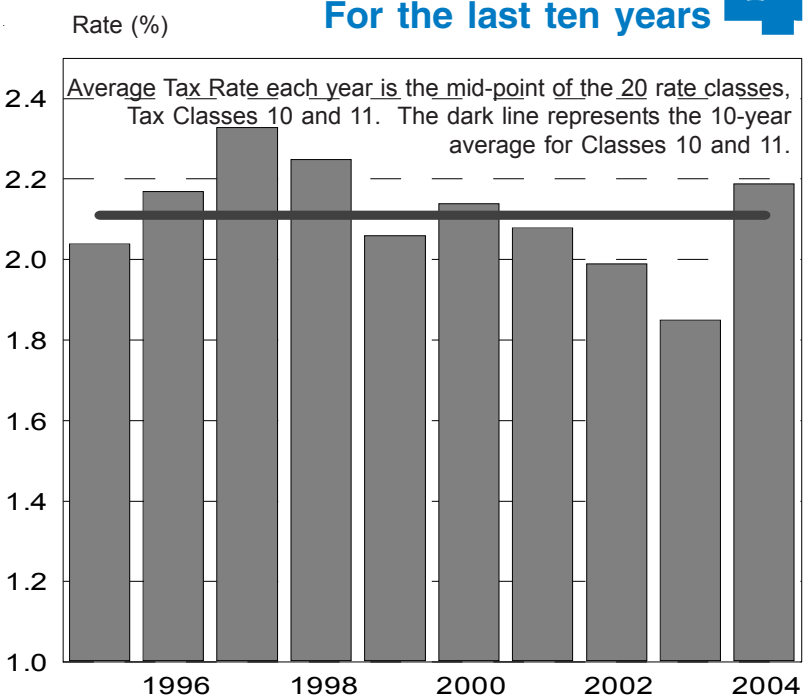
State Training and Employment (STEP) and Training and Vocational Education Programs (TVEP) are the exception to sole use of tax money for benefits. The legislature created STEP in 1989 and TVEP in 2000, which use a portion of the collected UI employee tax for worker training programs. Each program is authorized to receive 0.1 percent of taxable wages covered by the employee tax. These funds are not deposited into the UI trust fund.

component of the tax system. For 2004, the UI taxable wage base is $27,100. (See Exhibit 3 for a year-to-year comparison.)

Solvency adjustment

Normally the basic tax rate calculation process is sufficient to replace the cost of benefits paid out and keep the trust fund balance at its target. Bear in mind the two purposes of the tax system: (1) Pay for benefits spent from the trust fund, and (2) Maintain sufficient reserves in the trust fund. Alaska statutes establish that the balance in the trust fund should equal about 3.2 percent of total wages in the state economy, a figure that proved accurate during the severe recession following the 1986 oil price crisis. Occasionally, when the balance of the trust fund lags behind this goal, the tax system imposes a surcharge to help catch up. Also, if over-funded, the system gives employers a credit on tax rates. For six of the past eight tax years the solvency adjustment was a "zero," and for one year employers received a credit. A solvency surcharge was applied to the tax rates during 2004, for the first time since 1991, and will apply in 2005 as well.

Alaska UI Average Tax Rates 4
For the last ten years



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

Mechanics of the tax rate system

Nearly all wage and salary employment is considered as "covered" by the scope of the unemployment insurance system, and in this discussion, for simplicity, we will use "employment" and "covered employment" as if it were the same thing, although technically it is not. All employees who work for a "covered" employer are potentially eligible for UI benefits, depending on their qualifying earnings.

Taxable and reimbursable employers

All covered employers participate in the UI system, and are designated either as "taxable" or "reimbursable" employers. Most firms in Alaska are taxable employers, who report employment, wages, and pay UI taxes on a quarterly basis. Other entities do not pay taxes, but reimburse the system for the benefits paid to their former employees. Reimbursable employers include state and municipal governments, and some private non-profit organizations.

Experience rating

The majority of firms are "experience rated" employers, who qualify for inclusion in the experience rating system because they have reported at least four quarters of wage history to the Department of Labor and Workforce Development. These firms are assigned to one of 20 rate classes under the experience rating system. New firms which have fewer than four quarters of wage history are assigned an industry average rate, basically the average of the tax rates paid by all experience rated firms in the same industry. A third class of taxable employers belong to the "penalty class," a status to be avoided.

Several experience rating systems are in use in the United States. Alaska uses the simplest. A firm whose wage history shows a high degree of variability in employment is assigned a rate that is higher than a firm with a more stable employment pattern. Each year the past 12 quarters of wage

history is used to calculate the "payroll decline quotient" for each firm. All the firms are then arrayed, from smallest to largest quotients, so that roughly five percent of the firms fall into each of the twenty rate classes. Class one will have the lowest tax rate, and class 20 the highest, with classes 10 and 11 having the average tax rate.

Tax Rate Calculation

The tax rate calculation for employers has three components, which we will cover here in a simplified manner. The three steps are: 1. Calculate the Average Benefit Cost Rate; 2. Apply the Experience Rating Factor; and 3. Apply the Solvency Adjustment Factor, if other than zero.

(1) Average Benefit Cost Rate. The cost of benefits paid out determines the tax rate needed to replace that payout in the trust fund. The average Benefit Cost Rate is the cost of benefits for the past three years compared with total payroll in the economy for three years. The principle of "counter-cyclical financing" is applied using three years of data. The product of this first step is in essence the percent of (or tax rate to equal) wages in the economy needed to replace the benefits paid out. The product of this calculation then is divided so that employers will pay 80 percent of it and employees will pay 20 percent. The employer portion becomes the average employer tax rate.

(2) Experience Rating Factor. Once the Average Employer Tax Rate is obtained, the tax rates for each of the 20 rate classes is computed, by applying the "Experience Rating Factor" for each tax class to the Average. Classes 10 and 11 are the Average Rate Classes. The factors for classes one through nine will result in lower than average rates, with class one having the lowest. The factors for classes twelve through twenty will result in higher than average rates, with class twenty having the highest.

(3) Trust Fund Solvency Adjustment. The balance in the trust fund is compared to the total wages in the economy to determine if a solvency surcharge, or credit, is needed as an adjustment to the tax rates for the twenty tax classes. If other than zero, this solvency factor (rate) is added to, or subtracted from, the tax rates.

Summary

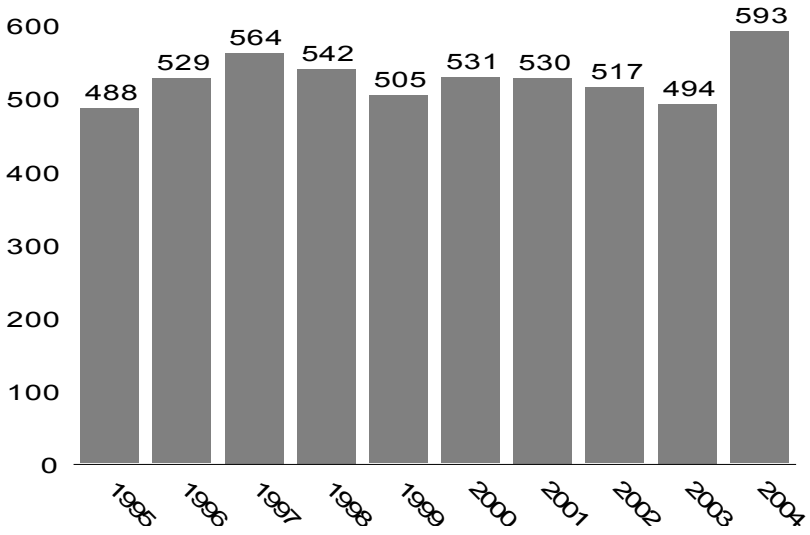
Alaska's Unemployment Insurance system is supported with taxes paid by employers and employees, with tax dollars going to pay benefits only, not administrative costs. The Alaska system is responsive to changes in the economy and is self-adjusting so that trust fund solvency will be maintained. With the principle of counter-cyclical financing, the system is geared to buffer changes in tax rates, and smooth out the tax needs over time. Employers who have more stable employment histories enjoy lower tax rates under the experience rating system. Dollars paid out in benefits help to stabilize the economy and maintain availability of an experienced workforce for employers.

For more information about the UI tax system see the Department's web pages, which include the Alaska Employment Security Tax Handbook, available at http://www.labor.state.ak.us/estax/taxbook.pdf.

Directions to web pages
"How the Tax Rates are Calculated"
Go to www.almis.labor.state.ak.us
Follow links on left side bar
Unemployment
Unemployment Insurance Program
See "How is it calculated?" at bottom

Maximum Cost for Each Worker 5

Earning the taxable wage base



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