

# Unemployment Tax Changes

About the year's lower rates and tweaks to the system

States' unemployment insurance systems provide temporary payments to people who, having paid into the system, lose their jobs. In Alaska, both earnings and working duration determine how much people can draw in benefits and for how long.

In addition to providing payments to displaced workers, the system is designed to stabilize economies during downturns, partly by replacing some of those workers' income in the local economy and partly by making it possible for workers to remain in their area and be available for future work.

## Every state is different

States administer unemployment insurance programs with federal oversight and financial support. It's not an exaggeration to say there are 50 combinations of eligibility requirements, benefit

amounts, and systems for collecting taxes to pay benefits.

Alaska is one of three states where employees pay a portion of the total tax. (See Exhibit 1.) Alaska's system also self-adjusts, meaning taxes are mostly set automatically by formulas meant to keep the system prepared to weather a recession.

Alaska was one of only about a dozen states whose UI systems didn't become insolvent during the recession of the late 2000s. The recession didn't hit Alaska as hard, and Alaska's unemployment insurance system had sufficient reserves to get through several years of benefit costs exceeding the tax revenue it brought in.

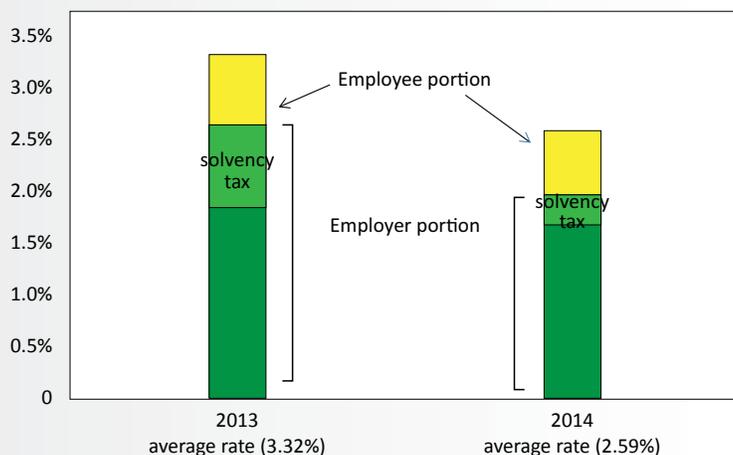
Alaska's UI tax rates adjust to demands on the system. For example, if more people suddenly file claims for benefits, those extra costs would create a need for extra revenue, and UI tax rates would rise to replenish the fund — though not immediately and not all at once.

Exhibits 2 and 3 show Alaska's overall trust fund balance and how "solvent" the fund has been over time. It's important to understand that solvency is more complicated than just the amount of money in reserve. The fund is considered fully solvent when it has enough funds to cover a certain percentage of wages in the state — known as the "reserve ratio" — currently between 3.0 and 3.3 percent, by statute.

## Alaska's rates rose, then fell

Alaska recently had four consecutive years of rising unemployment insurance taxes due to the after-effects of the national recession, which technically ended in 2009. Because of increased costs and a reserve depleted by an increased claims load, taxes rose to replenish the fund. (See

### 1 Employer, Employee Shares of Tax Rate Alaska UI, 2013 and 2014



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

#### Exhibit 4.)

Those four years of higher rates allowed the fund to regain some lost ground, building the reserve by \$65 million over the last federal fiscal year. This brought the total fund to \$329.5 million by September 2013.

Because of this recovery in the trust fund and falling benefit costs, tax rates fell for 2014. This year's average total tax rate, which combines employee and employer contributions, is 2.59 percent — a 22 percent reduction from 2013's rate of 3.32 percent.

The final tax rates are based on two factors: first, how much is in the fund at the end of each fiscal year, and second, what's necessary to recapture costs. If the fund is at a lower level than its statutory target, employers pay an additional "solvency tax" to bring the fund up to its target range, or reserve ratio. (For more on the calculations and factors that help determine these rates, see the box on page 19.) The final tax is a combination of the cost-recovery rate and any additional solvency adjustment. The solvency adjustment can also be a credit rather than a tax if the reserve ratio is above its target level.

### Recently enacted legislation

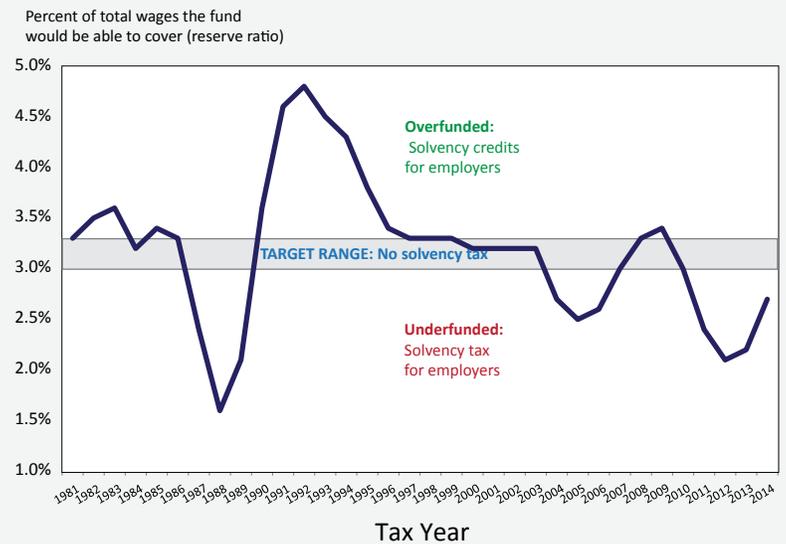
Two legislative changes were made to the system in 2013, with the intent to keep taxes as low as possible while maintaining sufficient reserves in the trust fund: 1) Taxes may now fall faster after reserve funds are replenished; and 2) policy makers now have the discretion in some cases to keep taxes lower for longer.

The first change affects the solvency tax mentioned earlier. Before, the solvency tax could only increase or decrease by three-tenths of a percentage point from one year to the next. The restrictions on increases were meant to shield employers from a sudden jump in taxes.

As of 2014, though the three-tenths of a percentage point restriction remains in place for rising taxes, there's no longer a limit to how fast the solvency tax rate can fall. This means that for 2014, the solvency tax rate was able to

## 2 Trust Fund Solvency Range

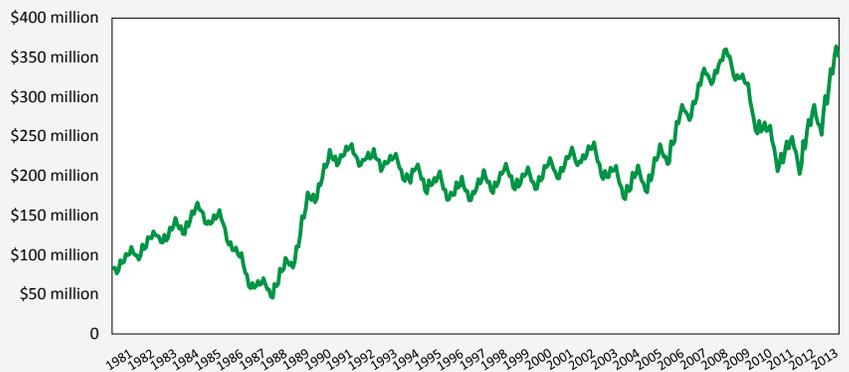
By percent of all wages coverable, 1981 to 2014



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

## 3 Monthly Trust Fund Balance

Alaska UI, 1981 to 2013



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

## How tax rates are calculated

Two main factors influence the calculations of unemployment insurance tax rates: 1) cost recapture, or the “average benefit cost rate,” and 2) the trust fund balance on Sept. 30, which is the end of the federal fiscal year. This balance determines whether an additional solvency tax is necessary.

The average benefit cost rate, or ABCR, is the sum of the most recent three state fiscal years of UI benefit costs as a percentage of covered wages, divided by the ratio of taxable to total wages. The three-year average is to shield employers from bearing the full brunt of increased costs during a recession. This portion of the total tax is split by employers and employees, 73/27.

Benefit costs used for calculating the 2014 rates totaled \$474.6 million, which consists of payments made in state fiscal years 2011, 2012, and 2013. This three-year figure was down \$28.4 million from last year. (See Exhibit 1.) This \$474.5 million made up 1.41 percent of covered wages.

With the ratio of taxable to total wages coming in at 61.49 percent, the average benefit cost rate used for 2014 tax rates was 2.30 ( $1.41 / .6149 = 2.30$ ) percent, which was down 0.22 percentage points from 2.52 percent in 2013. (See Exhibit 1.)

The additional solvency tax, paid by employers only, comes into play when additional revenue is necessary for the fund to be solvent. The solvency tax, which was 0.8 percent in 2013, has been reduced to 0.29 percent for 2014 — equal to the difference between the targeted reserve ratio of 3.0 percent and the current reserve ratio of 2.71 percent.

Currently, tax contributions change by roughly \$7.5 million for every tenth of a percentage point in the tax rate. Therefore, the statutory change that resulted in an additional .21 percent reduction in the solvency tax reduced the total UI tax take by \$15.75 million.

For a more in depth description of how UI tax rates are calculated, please visit the Alaska Department of Labor and Workforce Development Web site at [laborstats.alaska.gov/uiprogram.htm](http://laborstats.alaska.gov/uiprogram.htm) and follow the links for “UI Finance and Tax Rate Calculations.”

drop by 0.51 percentage points, whereas under the previous rules it could have fallen by a maximum of 0.3 percentage points. (For more explanation of the solvency tax, see the box at left.) This reduced the 2013 solvency tax rate of 0.8 percent to 0.29 percent for 2014.

The second change grants the commissioner of the Department of Labor and Workforce Development the discretion to suspend tax rate increases when the calculations call for them as long as the fund reserve meets or exceeds a certain threshold. This law, which is in effect through state fiscal year 2016, is explained in more detail by the box on page 19.

## Effects of these two changes

The effect of the first change was felt immediately in 2014. The effects of the second will depend on how often the criteria that allow the discretion to be used are met, and on whether and to what degree the discretion is actually used.

While neither change will significantly alter the total revenue collected over the long term, they will affect the rate at which the trust fund is replenished and could also alter the proportions paid by employers and employees.

### **More precision in replenishing the trust fund:**

The normal pattern following a downturn in the economy is a measured ratcheting up of the solvency tax as costs outpace contributions for several years in a row. As claims and payments begin to fall and the trust fund recovers, those solvency taxes begin to reverse as well.

However, with the former limits on how fast the solvency tax could fall, the fund would often recover quicker than the tax could come off by law. This would sometimes lead to overfunding the reserve for a short time, but would even out as those extra funds would be used to prepay future taxes and buffer the future need for higher rates.

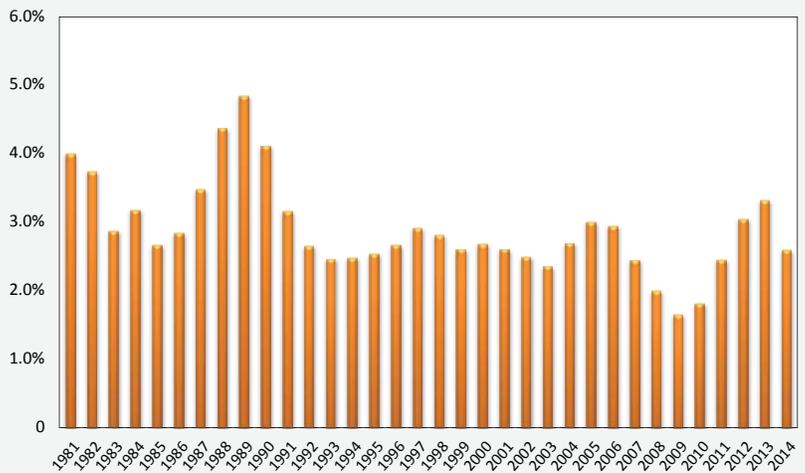
With no limit this year on how fast the solvency tax can decline, there’s much less chance of overfunding the reserve. This means more overall stability for tax rates, with fewer instances of overpaying the system.

**Effects on proportions paid by employers vs. employees:** The second change may also affect the timing of fund replenishment, depending on how the discretionary power to suspend tax increases is exercised. This discretion could also affect the employer/employee shares of the tax.

As mentioned in the box on page 18, the final tax rate is made up of the cost-recovery rate plus any additional solvency tax. The first part is split 73/27 between employers and employees, as defined by Alaska statute. The second component, the solvency tax, is a “recession readiness” portion paid solely by employers. As the economy fluctuates, so may the necessary solvency adjustment. That means that if a rate increase that includes the employee share is suspended, solvency taxes will respond accordingly in subsequent years to make up the difference.

Normally, as costs increase and begin to outpace tax revenue, the system will call for a tax increase. If that automatic increase is suspended, the system will recoup its costs slower and the balance would fall further than it would have otherwise. Eventually, tax rates would then have to rise more than they would have without the suspension to bring the fund back into its target range.

## 4 Average UI Tax Rates by Year Alaska, 1981 to 2014



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

### New law allows suspension of rate increases

Sec. 23.20.291 took effect in state fiscal year 2014 and is set to expire in state fiscal year 2016. This new statute gives the commissioner of the Department of Labor and Workforce Development the authority to suspend automatic rate increases and points to the “average high cost multiple” the department produces as another way to judge solvency. As long as the average high cost multiple is at least 0.8, the commissioner can exercise this discretion.

The average high cost multiple is the ratio of two separate calculations. While the numerator represents the current trust fund reserve ratio or trust fund balance as a

percentage of covered wages, the denominator (the “average high cost rate”) is the average of the three most recent high-cost years as a percentage of covered wages, as posted by the U.S. Department of Labor.

So, for example, if the current trust fund reserve ratio and average high cost rate are equal, the average high cost multiple is 1, or 100 percent, which means the trust fund can absorb benefit costs equivalent to the average of the three most recent high-cost years as a percentage of covered wages, without collecting any extra revenue.