

Maryland Policy *Reports*

Analysis from the Maryland Budget and Tax Policy Institute

Reforming Maryland's Unemployment Insurance Taxes

Options to Avoid UI-Related Tax Increases and Benefit Cuts During Recessions

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Summary

- Maryland employers are currently facing an across-the-board increase in unemployment insurance taxes starting in January, 2004.
- This increase will occur not because the state's UI benefits are overly generous, or because the current economic slowdown has been particularly harsh, but because the state's unemployment insurance taxes are insufficient, preventing a build-up of adequate trust fund reserves during the economic boom of the late 1990s.
- Maryland's UI taxes are essentially a pay-as-you go system that increase taxes on employers when they can least afford them. Maryland policy makers may wish to reform state UI taxes to build up sufficient rainy-day reserves during prosperous periods, thereby avoiding tax increases during future economic slowdowns.

To accomplish this, state policy makers may want to consider:

- raising basic UI tax rates, the taxable wage base, or both to shore up the trust fund and avoid trigger-based surtaxes during recessions;
- altering the current pay-as-you-go system, lowering the level at which taxes are automatically increased (usually during recessions), and raising the level at which taxes are automatically lowered (so that surpluses can build during prosperous times).

Introduction: A System in Trouble

Maryland's unemployment insurance program is in financial trouble. Absent a change in state law or an unexpectedly rapid economic recovery, dropping levels in the state's unemployment trust fund reserves are expected to trigger an across-the-board tax increase on employers starting in 2004 (see chart below). This increase is likely to remain in effect for several years, and possibly indefinitely.

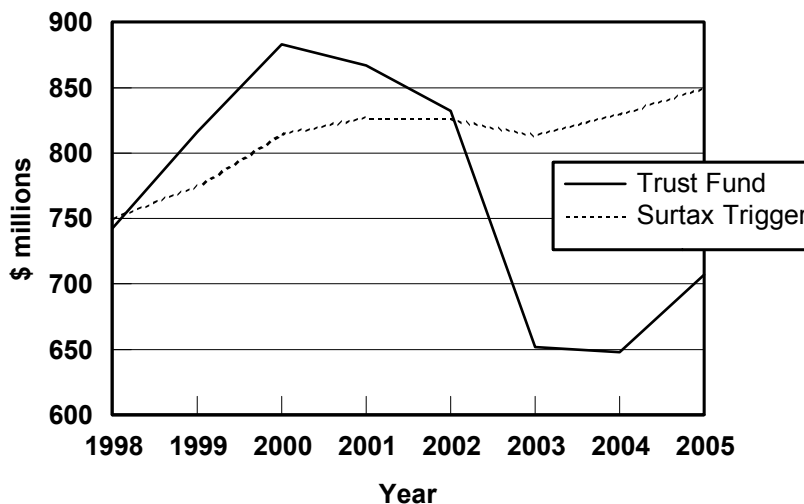
The coming financial squeeze is not the result of an overly generous benefits package. Maryland has one of the least generous unemployment insurance programs in the country. While 43 percent of the nation's unemployed are collecting unemployment benefits at any given time, that rate is only 34 percent in Maryland. Maryland's average weekly benefit of \$241.57 is below the national average. It is also much closer to the low end of the range when compared to the other 50 states — where benefits range from a low of \$205 per week in Arizona to a high of \$496 per week in Washington state.¹

This paper is the third in a three-part series on unemployment insurance in Maryland. The first paper in the series, "Maryland Unemployment Insurance: Underfunded and Out of Date," examined UI benefits and financing in broad terms. The second, "Fixing Maryland's Unemployment Safety Net," reviewed options for addressing some of the largest shortfalls in state benefits.

The program's financial troubles are only tangentially related to the economy. Like the rest of the nation, Maryland experienced several years of record low unemployment in the late 1990s, a prosperous period during which significant reserves should have been built up in the state unemployment insurance trust fund. That did not happen. Moreover, while the state presently is experiencing an economic slowdown, the state's unemployment rate was only 4.6 percent in July, making this one of the milder downturns in recent

UI Trust Fund and Trigger Levels

Actual and Projected Data



Note: The surtax trigger is the level of UI trust fund reserves required to avoid triggering an across-the-board tax increase on employers.

Source: MD Department of Labor, Licensing, and Regulation, "Unemployment Insurance Briefing,": January 28, 2003, p. 20.

history. Nevertheless, this mild downturn has been sufficient to cause a significant draw down of trust fund reserves.

The primary reason for the current financial crunch, therefore, is not an overly generous benefits package or a sharp economic downturn. Instead it is an inadequate tax system that is failing to generate enough revenue to support a modest program.

One Trust Fund, Two Tax Systems

Maryland's UI trust fund plays a central role in financing the program. As in every other state, the trust fund is separate from the rest of the state budget. The trust fund is actually a federally-managed account, and unlike other Maryland trust funds, this one can not be drawn down for other purposes. This protects the program from budgetary pressures that normally apply to state programs during a recession, when tax revenues fall and deficits become problematic. The program's designers understood that unemployment insurance would be needed most when the economy was performing poorly. The trust fund was created as a permanent rainy-day fund that would ensure a smooth flow of payments during economic slowdowns.

Under this approach, unemployment insurance taxes should be reasonably stable over time. Trust fund reserves should build up during prosperous times, when unemployment is low, and be spent down during recessions, when unemployment is higher. This acts as an economic stabilizer, softening the economic blow during economic downturns. Providing increased benefit payments and ensuring stable (if not lower) taxes during a recession stimulates the economy.

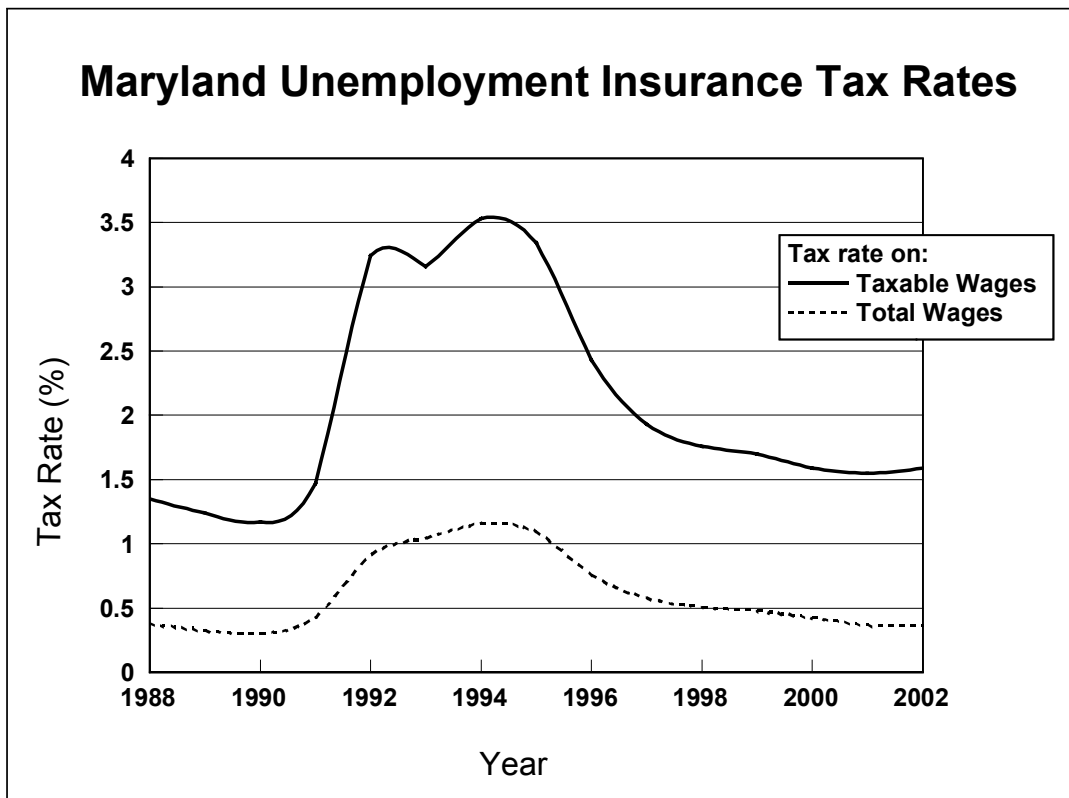
Unfortunately, these counter-cyclical economic ideas have, in practice, broken down in Maryland. Maryland's UI tax structure has increasingly become a pay-as-you-go system, with employers

paying lower taxes during economic boom years and higher taxes during economic slowdowns. Absent a change in current law, Maryland employers can expect to see a significant tax increase starting in January, 2004, to cover the increased costs associated with the current slowdown.

Understanding why these increases are expected to occur requires understanding the basics of the state's unemployment tax structure. Under current Maryland law, there are actually two unemployment tax systems. The first taxes all state employers a variable tax rate, based on their record of layoffs. Under this system, which is known as "experience rating," employers pay a rate ranging from 0.3 percent to 7.5 percent of their taxable payrolls, depending upon the costs they have imposed on the system over the past three years. Tax payments are derived by applying this rate to the first \$8,500 in wages paid to each employee. Because this system is based on an employer's previous experience with layoffs, it is by necessity backward looking and tends to increase taxes during, and immediately after, an economic slowdown.

The second set of taxes is applied less regularly. Under this system, a surtax is levied on all employers throughout the state, regardless of their layoff history, when reserves in the trust fund fall below a designated level. This determination is made every September 30. If on that date the reserves have fallen below 4.7 percent of the previous year's state-wide taxable wages, a surtax is triggered and becomes effective starting in January of the following year. On September 30, 2002, the trigger level was \$827 million. At that time, Maryland's trust fund held \$834 million — a slim margin, but one sufficient to avoid the trigger. This will not be the case next September 30, however, when low reserve levels are expected to trigger an across-the-board surtax of approximately 1 percent starting in 2004.²

Maryland's trigger mechanism was meant to be a



safety valve, ensuring the program’s long run solvency. Ideally, revenues raised through the primary tax system should be sufficient to prevent a surtax from being triggered in any but the severest of recessions. Unfortunately, this is not the case.

Maryland’s trigger mechanism was invoked after the last recession in the early 1990s, one that was not particularly harsh by historic standards (see chart). If the state had not received an infusion of \$143 million in federal unemployment funds in 2002, the state would already be assessing a surtax on employers this year. Moreover, absent a change in state law, Maryland employers may be facing a perpetual trigger in the years to come.

Taken together, Maryland’s unemployment tax system is far from ideal. Both the experience-based primary tax system and the surtax system impose higher costs when employers can least afford to pay them.

Reforming Maryland’s Unemployment Tax System

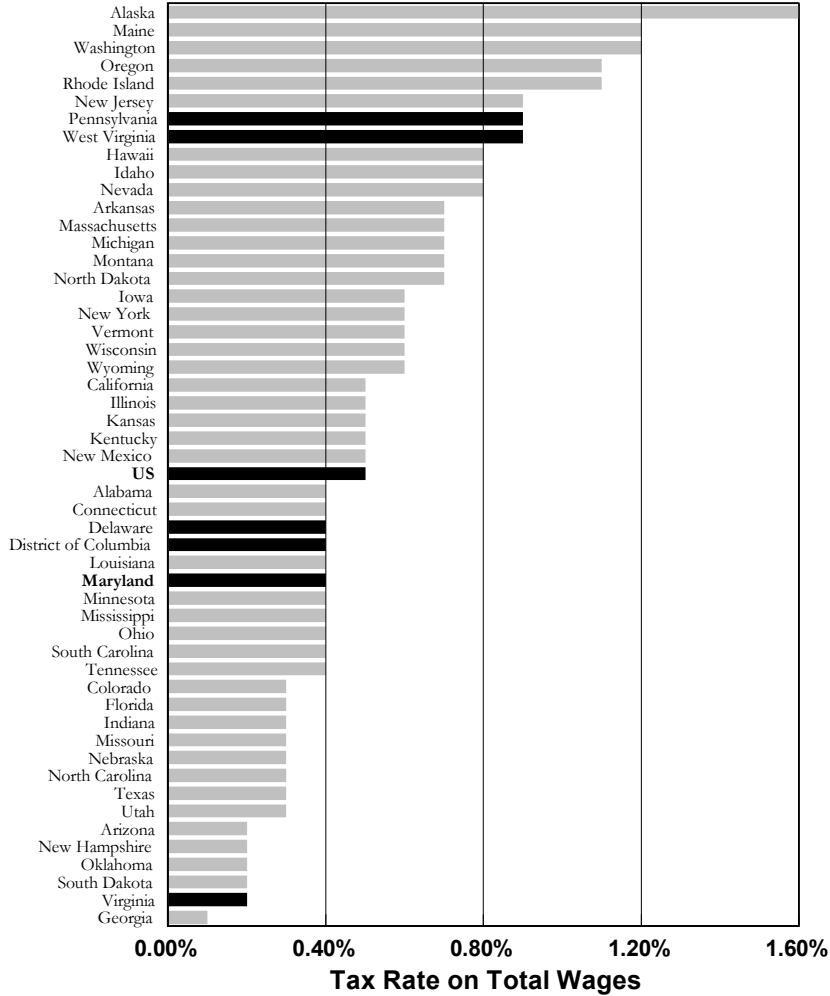
If Maryland policy makers choose to reform the state’s unemployment tax system, they may wish to consider the following options:

Option #1 - Avoid Surtaxes by Solidifying the Primary Source of Tax Revenue

Maryland could move away from its current pay-as-you-go system by adopting modestly higher taxes during prosperous economic times, thereby building a higher level of trust fund reserves. Doing so would allow the state to move away from poorly-timed, trigger-based surtaxes during recessions, which should only be used as a funding mechanism of last resort

Overall, Maryland unemployment insurance taxes have been, and are, very low. The tax rate as a percentage of all wage income in the state is under 0.4 percent, which ranks it below the national

Average State UI Tax Rates, 2001



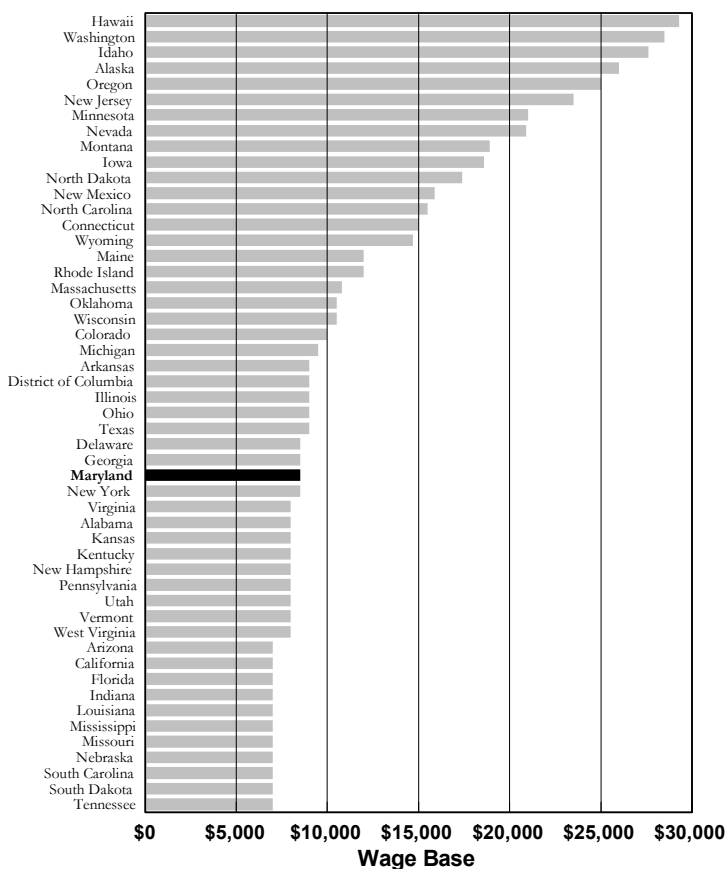
Source: U.S. Department of Labor, Employment and Training Administration. Data is as of the fourth quarter (October 1 - December 31), 2001.

average (see chart). These figures, however, are merely a snapshot of a given period of time. These average rates are slated to rise substantially as across-the-board increases come into play next year.

The state's options with respect to the coming surtaxes may be limited, but steps can be taken to avoid a repeat of this situation in the future. Toward that end, there are at least two sub-options for reforming the state's primary unemployment insurance tax structure.

- Increase the Taxable Wage Base:** UI taxes in the state are only applied to the first \$8,500 in wages earned per year by each employee in each job. By comparison, the wage bases in other states range from a low of \$7,000 (the minimum required by federal law) to highs ranging from \$26,000-\$29,000 in states like Hawaii, Idaho, and Washington state (see chart). Even these wage bases could be considered low, however, when compared to taxable wage bases for other programs like

UI Taxable Wage Bases, 2002



Source: U.S. Department of Labor, "Comparison of State Unemployment Insurance Laws: 2002," pp. 2.4-2.5

Social Security, where the wage base in 2003 is now \$87,000.

Increasing Maryland's taxable wage base would provide additional revenue in the short term, but the value of this increase will be eroded by inflation over time. A more permanent fix would involve raising the taxable wage base and indexing it to inflation or wage growth.

Interestingly, a significant increase in the taxable wage base could be accompanied by a cut in UI tax rates. If structured appropriately, this could actually reduce taxes paid by employers with low wage employees, like restaurants and small retailers, while increasing

revenues raised for the program overall.

- Increase UI Tax Rates:** As in every other state, unemployment insurance tax rates vary based on the layoff history of the employer. Tax rates range from 0.3 - 7.5 percent, with employers that impose larger costs on the system facing higher tax rates. According to the state's Office of Unemployment Insurance, however, these rates are only sufficient to recover about 62 percent of the costs imposed by on the system by employer layoffs overall.

This shortfall is a major reason why the program is chronically under-funded. It is due to a variety of reasons, including: costs can not

be recovered from businesses that have laid off workers because they have gone out of business; the maximum 7.5 percent rate does not collect sufficient revenues from employers that impose costs on the system that would warrant a higher tax rate; and assorted “noncharging” rules that do not assess employers for costs imposed on the system under certain circumstances.

This chronic imbalance could be addressed by increasing rates across the board by approximately one half. Addressing this chronic shortfall, which occurs at all times -- good and bad -- would do a great deal to help prevent much larger tax increases during economic slowdowns.

Option #2 - Change Maryland’s UI Trigger

Maryland’s trigger automatically imposes a surtax on employers if trust fund reserves fall below 4.7 percent of the previous year’s taxable wages. According to the state’s Office of Unemployment Insurance, declining levels in the state unemployment insurance trust fund are projected to trigger a 1 percent across-the-board tax increase on the state’s employers starting in January, 2004.³

Maryland’s trigger mechanism is meant to ensure the long run financial stability of the state’s UI program. Unfortunately, it is a very crude instrument that fails to allow adequate reserves to build up during prosperous periods, and may be too quick to raise taxes during economic slowdowns.

Not every state has a trigger. Only about half do, and many of those set their triggers at levels lower than Maryland’s relative to the size of their trust funds. Rhode Island, for example, does not assess a surtax until the fund balance dips below zero. This makes Maryland one of the more fiscally conservative states in the nation with respect to UI financing, which has helped ensure the program’s

long-run viability.⁴

The state’s trigger mechanism is not without its problems, however. While the trust fund is meant to be a rainy day reserve, Maryland’s trigger does not vary with the current conditions of the economy. Instead of allowing trust funds to be drawn down during economic slowdowns, which is normally the purpose of a rainy day fund, it is designed to force an across-the-board tax increase. This may help ensure the program’s fiscal solvency, but it is poor economic policy -- increasing taxes on the state’s businesses at a time when they can least afford them. The General Assembly can and has responded to this flaw, however, by altering the trigger when necessary. In 1990, during the last recession, the General Assembly enacted legislation temporarily capping trigger-based surtaxes for three years, through June 30, 1993. The General Assembly could repeat those actions

What Happens If the Trust Fund Goes Broke?

Under federal law, if a state’s unemployment insurance trust fund is depleted, it may borrow money from the federal government to pay benefits. The state must pay interest on its outstanding debt, however, and this interest must be paid from the general fund, not the unemployment insurance trust fund. Such borrowing is not common, but it does happen. Seven states borrowed money from the federal government during the last recession in the early 1990s.⁵

Federal borrowing is not limitless, however. If outstanding loans are not repaid within three years, federal unemployment tax rates are automatically raised on every employer in the state. This rate is increased every year until the outstanding debts are paid.⁶

today, capping and/or delaying tax increases until after the economy has fully recovered.

In the long run, the best way to avoid poorly timed, trigger-based tax increases while keeping the unemployment program solvent is to build up sufficient reserves during economically prosperous periods. Unfortunately, Maryland's trigger is not designed to do this. Because the overall system is underfunded, trust fund reserves stayed essentially flat during the boom period of the late 1990s. But even if the system were fully funded, there is currently an upper-level trigger that generates automatic tax cuts when reserves are above 5.5 percent of the previous year's taxable wages. This upper limit would prevent the creation of a reserve large enough to avoid tax increases when the economy slows down. If policy makers wish to avoid trigger-based surtaxes during future recessions, they may wish to revise this upper limit so the trust fund can build additional reserves during prosperous periods. Revising the upper limit

will not, alone, ensure the long run viability of the program, but it will help ensure that other changes to shore up program finances are not undermined.

Conclusion

Unemployment insurance benefits in Maryland are among the least generous in the nation and the program is significantly underfunded. Nevertheless, the program is still unnecessarily burdensome for the state's employers because it imposes tax increases upon them when they can least afford them -- during and immediately after a recession. State policy makers should consider replacing this pay-as-you-go system with one that is sufficiently funded, building surpluses in the state trust fund during economically prosperous periods so that tax increases can be avoided during economic slowdowns. Doing so would help ensure a viable and stable program that is fair to both employers and employees.

End Notes

- ¹ For more information on UI benefits in Maryland, see Maryland Budget and Tax Policy Institute, "Maryland Unemployment Insurance: Underfunded and Out of Date," (January, 2003).
- ² Maryland Office of Unemployment Insurance, January, 2003.
- ³ Ibid.
- ⁴ U.S. Department of Labor, "Comparison of State Unemployment Insurance Laws: 2002," pp. 228-2.32.
- ⁵ Wayne Vroman, "Topics in Unemployment Insurance Financing," W.E. Upjohn Institute for Employment Research (1998), p. 99.
- ⁶ Ibid., p. 103.
- ⁷ U.S. Department of Labor, "Comparison of State Unemployment Insurance Laws: 2002," p. 2.3.

About the Maryland Budget & Tax Policy Institute

The Maryland Budget and Tax Policy Institute is a nonpartisan research organization that provides timely, accurate, and accessible analysis of state budget and tax issues. In addition to general budget and tax research and analysis, the Institute examines issues affecting vulnerable populations and the important community programs that serve them. For additional information on the Institute or to receive this newsletter on a regular basis, contact us at 301-565-0505 or visit our web site at www.marylandpolicy.com. This analysis was written by Patrick Lester.

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