

This memo was sent to members of the Unemployment Compensation Reform Joint Committee and the Kasich administration

MEMORANDUM

Subject: Proposals to Restore Solvency to Ohio's Unemployment Compensation Trust Fund

Date: August 2016

Earlier this year, Policy Matters Ohio retained Dr. Wayne Vroman of the Urban Institute to review Ohio's unemployment compensation (UC) system and examine proposals to improve it and bring it to solvency. Dr. Vroman is one of the foremost authorities on UC financing and the Ohio Department of Job & Family Services previously contracted with him to analyze Ohio's UC system and make solvency recommendations. At Policy Matters Ohio's request, Dr. Vroman analyzed a number of proposals aimed at boosting solvency of the trust fund. This memo reviews that work and makes solvency recommendations based on the results.

In summary, Dr. Vroman found that well-tailored increases in employer taxes, coupled with a new tax on employee wages, could bring the fund to solvency by 2025, while improving the share of Ohio jobless who receive UC benefits by reducing monetary eligibility requirements. The analysis includes a mild recession that would increase the benefit payout.

Based on Dr. Vroman's analysis, Policy Matters Ohio proposes a balanced approach that achieves solvency through contributions by both employers and employees, without the benefit cuts that characterized House Bill 394. Specifically, the proposal includes a \$14,000 taxable base and a 0.15 percent tax on employee wages, both of those phasing down when solvency is reached; a 1.0 percentage point increase in the tax rate for employers whose taxes are now capped and do not pay the full cost of their laid-off employees' benefits; direction of all of the minimum-safe-level tax into the trust fund, and an increase in the mutualized rate, which covers unrecovered or ineffective charges; and a reduction in the minimum earnings amount for workers to qualify for benefits that would correct the long-standing exclusion of many low-wage workers. All of the changes would begin in 2018. The modeling assumes that the UC trust fund will have \$425 million in it as of yearend 2016.¹ Dr. Vroman used the same solvency target as the one used in HB 394 and by the U.S. Department of Labor.

In contrast, House Bill 394, with its drastic benefit reductions, would not bring the trust fund anywhere near solvency by 2025 according to the analysis provided by the Ohio Department of

¹ It also assumes that, in line with House Bill 390 approved last spring, Ohio repays its debt to the U.S. Treasury during 2016. The additional one-time state tax employers will pay next year to repay the state loan is not included in the model.

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Job & Family Services and used by the Legislative Service Commission.² HB 394 falls far short of that even though the fiscal analysis was done without inclusion of a recession between now and 2025.

As a starting point, Dr. Vroman's analysis looked at how the trust fund would fare if no policy changes are made and unemployment remains constant at the 5 percent level between 2016 and 2025. Like ODJFS, Dr. Vroman found that over time, benefits outrun taxes and the fund falls into the red.³ (See Table 1)

Factoring in a recession

However, assuming no recession is unrealistically optimistic; a 15-year recession-free period would be unprecedented. Dr. Vroman included in his estimates the effects of a modest recession, which will increase benefit levels. His recession scenario is based on statewide unemployment levels during and after the early 1990s recession between 2017 and 2021.⁴ Including a recession adds nearly \$1.8 billion in benefits over the period. This scenario, as shown below in Table 1, does not truly capture how employer taxes would be affected, in that renewed federal FUTA credit offsets would start to cause an increase in revenues in 2020 and help to restore the trust fund in a manner similar to their effects in 2012-2016. However, Table 1 illustrates how even a mild recession would increase benefit payouts and lead to a large negative trust fund balance.

² Ohio House of Representatives, Insurance Committee, Nov. 10, 2015, HB 394 Impact Analysis, Solvency Comparison, at <http://www.ohiohouse.gov/committee/insurance>

³ Dr. Vroman's estimates show the fund with a negative balance in 2024, while ODJFS puts it in 2025, according to estimates the agency provided to Policy Matters Ohio in mid-July.

⁴ Specifically, it is based on annual Total Unemployment Rates between 1990 and 1994 of 5.7, 6.6, 7.4, 6.7 and 5.6 percent. Other years in this simulation remain at 5.0 percent.

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Table 1 Current System – No Recession and Mild Recession
(all data in millions of dollars)

Year	Er Taxes (1)	Interest (2)	Benefits (3)	Trust Fund (4)	Year	Er Taxes (5)	Interest (6)	Benefits (7)	Trust Fund (8)
No Recession, Total Unemployment Rate = 5.0%					Mild Recession, 2017-2021				
2016	1,053	0	963	425	2016	1,053	0	963	425
2017	1,013	10	975	473	2017	998	7	1,242	188
2018	973	10	1,015	441	2018	963	0	1,571	-421
2019	979	9	1,048	382	2019	992	0	1,834	-1,263
2020	998	8	1,087	306	2020	1,089	0	1,379	-1,552
2021	1,018	6	1,117	212	2021	1,163	0	1,086	-1,475
2022	1,072	4	1,153	136	2022	1,229	0	1,059	-1,197
2023	1,116	2	1,190	64	2023	1,244	0	1,190	-1,144
2024	1,149	1	1,229	-15	2024	1,268	0	1,229	-1,105
2025	1,183	0	1,235	-67	2025	1,283	0	1,235	-1,057
2017-25	9,500	49	10,042		2017-25	10,229	7	11,826	

Source: Simulations with a trust fund model developed at the Urban Institute. Trust fund balances are as of the end of each year.

The policy changes modeled by Dr. Vroman omit the long list of benefit cuts in House Bill 394. Such cuts would harm Ohio families, and reduce the effectiveness of the UC program in providing added spending to the economy when it is needed. They also would harm unemployed workers' ability to seek employment. All of this undercuts the basic purposes of the unemployment compensation system since its creation under the Social Security Act of 1935. *The General Assembly should start afresh with a new bill.*

As previously noted,⁵ Ohio's UC fund went broke primarily because it was inadequately financed. Ohio's taxes are below the national average and have been for most of the last 20 years. According to figures from the U.S. Department of Labor, Ohio was tied for the 3rd weakest solvency position *prior* to the beginning of the last recession in December 2007. A crucial element of any solvency plan is more robust employer contributions.

Possible plan provisions

A balanced UC financing plan could avoid the benefit cuts of HB 394, while adding an employee contribution to help support the fund. That could be done with the creation of an employee

⁵ Schiller, Zach and Hannah Halbert, Policy Matters Ohio, Testimony to the House Insurance Committee on House Bill 394, Dec. 2, 2015, at <http://www.policymattersohio.org/testimony-unemployment-dec2015>

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tax, something that three states (PA, NJ and AK) already do. Such contributions are only reasonable as part of an overall package if employers also shoulder a responsible share of UC benefits; they should not simply shift existing employer UC financing obligations onto employees without substantively improving overall UC trust fund financing.

There are flaws in the existing UC tax system that should be fixed in any balanced UC financing plan. One of them is the current statutory requirement that half of the Minimum Safe Level (MSL) tax flows into the mutualized account, which is designed to repay the trust fund for unrecovered or ineffective charges (benefit charges that exceed taxes). This provision, along with another that credits to the mutualized account additional federal unemployment (FUTA) taxes paid to reduce federal trust fund debt, resulted in a zero mutualized tax for the last four years. Current ODJFS projections show a zero mutualized rate for years into the future. This makes little sense as mutualized charges continue to draw on the trust fund each year. Under the proposals Dr. Vroman modeled, the full MSL tax instead will flow directly into the trust fund. The mutualized rate is assumed to be 0.3 percent of taxable wages.

Under Ohio's current funding system, a relatively small number of employers pays the maximum tax rate (now set at 8.7 percent). These employers cost the system more in benefits than the UC taxes they pay. In tax rate year 2015, for example, these maximum-rated employers (with negative reserve balances of -20 percent of taxable payroll and lower percentages) paid \$202.3 million in UC taxes but incurred \$359.6 million in benefit charges, a drain on the trust fund of \$157.2 million. In order to bolster the trust fund and move closer to a truly experience-rated system, where employers are paying the charges incurred by their former employees, Dr. Vroman modeled an increase in the top tax rate by 1.0 percentage point. This increase still leaves these employers as a group paying considerably less than the charges incurred by their laid-off employees.

Dr. Vroman modeled the \$11,000 taxable wage base proposed in HB 394, which declines back to \$9,000 when the solvency target is reached. In addition, he included an employee tax, set at 0.2 percent of total wages. In order to ensure that not many workers find themselves paying a tax for a benefit they are not eligible to receive, he set a minimum threshold of \$12,600 in annual wages before the employee tax is assessed. He excluded this same share of wages throughout the period. This means that a worker making the Ohio minimum wage of \$8.10 an hour and working all year for 30 hours a week would not pay tax, nor would anyone on that share of their pay (Ohio's current earnings requirement is an average of \$243/week, or \$8.10 an hour x 30 hours, earned over at least 20 weeks). Under this scenario, a worker making \$40,000 would pay \$67.40 a year (\$1.30 per week) in such taxes.

Table 2 shows the proposal described above (including the \$11,000 wage base, the change in the MSL and mutualized taxes, the higher rate for maximum-rated employers, and the 0.2 percent employee tax). The baseline, with no policy changes, is repeated from Table 1.

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Simulation 1 includes the policy changes. Simulation 2 includes the policy changes and the effects of the recession. It shows the fund balance at the beginning, middle and end of the 2016-2025 period, as well as total employer taxes, employee taxes, interest the trust fund accumulated, and benefits over the nine-year period. It also shows the reserve ratio, which measures the trust fund balance at yearend as a share of covered payroll. The reserve ratio needs to be 1.37 percent or more for the fund to be fully solvent.

Table 2. Simulation Results – 2017 to 2025
(in millions of dollars, except for reserve ratios)

Variable	Baseline	Simulation 1	Simulation 2
Fund Balance 2016	\$425	\$425	\$425
Fund Balance 2020	\$306	\$2,039	\$86
Fund Balance 2025	-\$67	\$3,541	\$2,837
Reserve Ratio 2025	-0.03%	1.35%	1.08%
Employer Taxes	\$9,500	\$10,488	\$11,489
Employee Taxes	\$0	\$2,262	\$2,589
Interest	\$49	\$407	\$159
UI Benefits	\$10,042	\$10,042	\$11,826

Source: Simulation results with a trust fund model developed at the Urban Institute.

As Table 2 indicates, these solvency measures considerably improve the status of the fund. Under Simulation 1, with no recession, the trust fund is nearly solvent in 2025.⁶ Under Simulation 2, with a recession, the lowest year-end balance between 2017 and 2025 is minus-\$140 million at the end of 2019, the only year there is a negative balance. It illustrates, too, how a fund that is better financed accrues more federal interest, further adding to the fund and reducing tax payments.⁷ However, under Simulation 2, the fund ends 2025 with a balance of \$2.8 billion, still well short of the solvency target. Despite employee contributions of more than \$2.5 billion over that time period, and an increase in employer taxes, this is not enough to bring solvency at the end of the period.

Table 2 shows how an increase to an \$11,000 taxable wage base still leaves the fund with insufficient revenue. An \$11,000 wage base would still be well below the national average wage base of \$13,400, and below the more than \$14,000 that Ohio's would be if it had just kept up with inflation since it was last raised in 1995. In fact, a strong case can be made that Ohio's taxable wage base should be set at \$15,000 or more. If Ohio had increased its taxable wage

⁶ Under this scenario, the fund achieves solvency in 2024, but that triggers reductions in employer and employee taxes as both are reduced the following year. That causes the fund to drop below the solvency threshold in 2025. See below for more discussion of this simulation.

⁷ Dr. Vroman used an average interest rate of 2.25 percent throughout the period.

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base since 1995 by the same amount as the state average weekly wage, the wage base would now be \$15,660. It is plainly difficult for a tax that covers a very small share of wages to generate the necessary revenue.

Effects of a higher taxable wage base

Dr. Vroman separately reviewed how much revenue different taxable wage bases would generate. These simulations assume that the unemployment rate remains at 5.0 percent between 2017 and 2025. No other changes in taxes or benefits are included. Table 3 shows the results:

Table 3. Simulations with Alternative Taxable Wage Bases, 2017 to 2025
(in millions of dollars, except for reserve ratios)

Variable	Tax Base \$9,000	Tax Base \$11,000	Tax Base \$14,000
Fund Balance 2016	\$425	\$425	\$425
Fund Balance 2020	\$306	\$701	\$1,266
Fund Balance 2025	-\$67	\$848	\$2,062
Reserve Ratio 2025	-0.03%	0.32%	0.79%
Employer Taxes	\$9,500	\$10,328	\$11,421
Interest	\$49	\$137	\$257
UI Benefits	\$10,042	\$10,042	\$10,042

Source: Simulations based on the model developed at the Urban Institute. Taxes, interest and benefits are totals for the nine years 2017 to 2025.

Table 3 illustrates the effects of raising the taxable wage base. Over the nine years that are covered, the increase from \$9,000 to \$11,000 increases total revenue by about \$800 million (8.7 percent) while the increase from \$11,000 to \$14,000 boosts total revenue by an additional \$1.1 billion (10.6 percent). Still, even the \$14,000 wage base on its own leaves the fund well short of a fully solvent position in 2025.

Ohio's earnings test

One critical failing of Ohio's UC system is its exclusion of many low-wage workers who would qualify for benefits in other states. In 2014, its monetary threshold of \$4,660 represented 5.33 weeks of earnings measured at the statewide average weekly wage. Using this measure of monetary eligibility, only four state programs had higher requirements. This is one reason that Ohio persistently has had a smaller share of its unemployed receiving benefits than the national average – 24 percent in the 12 months ended March 31, 2016.

In his next simulation, Dr. Vroman included a reduction in the monetary requirement from the current 30 hours a week at the state minimum wage to 20 hours. This assumed an increase in the claimant caseload averaging 4 percent a year between 2017 and 2025. This simulation

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includes a moderate recession and other elements cited earlier: All of the MSL tax is directed to the state trust fund, the mutualized tax is assumed to be 0.3 percent of taxable wages and the tax rate is increased by 1.0 percentage points for all employers taxed at the maximum rate. He included an employee tax of .15 percent, beginning at the threshold of \$8,400, because the lower earnings test means someone earning more than that is likely to receive benefits should they become unemployed. He excluded this same share of wages throughout the period. Finally, he used a taxable wage base of \$14,000, which as described earlier, is less than the Ohio's wage base would be if it had just kept up with wages since it was last raised in 1995. Table 4 shows the results, including amounts in 2023, 2024, 2025 and over the nine-year period:

Table 4 0.15 Percent Employee Tax, Tax Base of \$14,000, Eased Monetary Eligibility

	2023	2024	2025	2017-2025 Flows
Tax Base	\$14,000	\$14,000	\$14,000	
Employer Tax	\$1,531	\$1,489	\$1,453	\$13,139
Employee Tax	\$290	\$300	\$310	\$2,182
Interest	\$46	\$59	\$71	\$234
Benefits	\$1,240	\$1,280	\$1,286	\$12,261
Reserve Ratio End of Year	1.02%	1.21%	1.38%	
Trust Fund Balance	\$2,505	\$3,072	\$3,620	

Taxes, benefits, interest and fund balances in \$millions.

This plan would bring the fund into balance in 2025, including a mild recession. Employers and employees alike would contribute, avoiding benefit reductions. For a worker making \$40,000 a year, the employee tax would cost about a dollar a week. Minimum-wage workers still would have to be employed at least 20 hours a week for 20 weeks to qualify for benefits, but the cost of bringing them into the system would be modest; without the improvement, Dr. Vroman calculated, the trust fund would still reach full solvency in the same year, 2025. Employers that currently do not pay the full costs of their laid-off workers' benefits would pay somewhat more. The \$14,000 wage base would be the same or less than that of 28 other states.⁸

Yo-yo effect

⁸ U.S. Department of Labor, Employment & Training Administration, Comparison of State Unemployment Laws 2016, pp. 2-4 to 2-5, at <http://oui.doleta.gov/unemploy/pdf/uilawcompar/2016/financing.pdf>

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The taxable wage base in House Bill 394 is set at \$11,000, but only until solvency is reached, at which point the wage base returns to today's \$9,000. Dr. Vroman reviewed the effect of this provision, together with some other changes, in Table 2, Simulation 1. However, as noted, this leads to a *yo-yo effect* on revenues and trust fund levels, especially when combined with an employee tax that triggers on and off all at once. This simulation includes four potential changes to program financing (an \$11,000 tax base, the higher maximum rate, redirection of MSL taxes, and an employee tax of .2 percent). This simulation was based on a steady unemployment rate of 5.0 percent (no recession) and no change in monetary requirements. The fund balance increases steadily after 2017, and reaches a peak of \$3.66 billion at the end of 2024. Because it reaches solvency at the end of that year, the employee tax and the higher taxable wage base both "turn off" in 2025. This causes total revenues to decline by \$490 million that year. This leaves the fund slightly below the solvency threshold at the end of 2025. This would mean both the higher taxable wage base and the employee tax would have to be reactivated in 2026. In successive years, employers and employees alike would see significant reductions and increases in taxes.

Such a herky-jerky tax system would not be desirable for either employers or employees, who could not plan from year to year on what their taxes would be. At a minimum, if there is to be a trigger mechanism, it should trigger off and on in stages. For instance, tax levels could be lowered over a two-year or longer period.

Dr. Vroman reviewed how this would work in another simulation, with the same scenario as that shown in Table 4 but with a higher 0.2 percent employee tax. This allows the fund to reach solvency in 2024, resulting in the reduction in the taxable wage base to \$9,000 and a drop to zero of the employee tax the following year. This causes tax revenue to be almost \$800 million lower in 2025 than 2024, so the fund drops below solvency again. If instead a two-year trigger was in place, the wage base would drop to \$11,500 in 2025, and the employee tax to 0.1 percent. This would mean a decrease of \$405 million in revenue that year, keeping the trust fund in balance and avoiding big tax swing in 2026.

Recommendation

Policy Matters Ohio recommends that legislators consider the scenario proposed in Table 4. This calls for a small tax on working Ohioans protected by a well-financed UC fund; a modernized system that allows low-wage Ohioans currently excluded to participate, while fixing flaws in the current tax system that contribute to its inadequacy; and significant additional contributions by employers, a crucial element of any plan since long-term underfunding is at the heart of our solvency problem. Both the employee tax and the taxable wage base would phase down over a two-year period when solvency is reached. This represents a balanced

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approach that attempts to provide a long-term solution to the solvency challenge. We do not support cherry-picking one or more elements of the plan, such as the employee tax, which must depend on improvements to the system and employer contributions as well. We hope you will consider this proposal, which solely reflects the views of Policy Matters Ohio, as you review the solvency issue.