

Solvency Recommendations for Ohio

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Executive Summary

This report makes a series of recommendations to improve the solvency of Ohio's unemployment insurance (UI) program. The recommendations fall into three areas: i) changes to improve solvency in the short run, ii) changes to improve solvency in the long run and iii) changes to alter access to UI benefits.

Two recommended short run changes are the following. If implemented they would increase the trust fund balance substantially in 2009 and later years, reducing the risk of insolvency and/or the scale of future borrowing from the U.S. Treasury.

Recommendation 1. Increase the taxable wage base in 2009

Recommendation 2. Freeze the maximum weekly benefit during 2009-2011

Two recommended changes to improve solvency in the long run are the following. If implemented these changes would help to ensure that the future growth of revenue will match growth in benefit payments and prevent the trust fund from declining as it has in the present decade.

Recommendation 3. Link Changes in the Taxable Wage Base to Growth in Average Wages

Recommendation 4. Redirect Revenues from the Mutualized Tax and the MSL Tax to their Original Intended Uses

Three recommended changes to alter access to UI benefits are the following. If implemented these changes would broaden access to UI benefits without increasing total benefit outlays in future years.

Recommendation 5. Ease the Requirement for Monetary Eligibility

Recommendation 6. Eliminate Dependents' Benefits

Recommendation 7. Consider Implementing Short Time Compensation (STC) and Self-Employment Assistance (SEA) Programs

Background

In the period since December 31, 2000 the balance in Ohio's unemployment insurance (UI) trust fund has decreased by roughly \$2.0 billion. At the end of December 2007 the balance stood at \$445 million or 20 percent of its level at the end of 2000. By March 2008 the balance had reached \$135 million, and to maintain benefit payments later this year and/or in 2009 the state may have to borrow from the U.S. Treasury.

The decline in the trust fund balance during the past eight years has been gradual but persistent with the annual loss of reserves exceeding \$100 million in five separate years. The largest annual decrease was \$650 million during 2003, but a similar decrease would have occurred in 2002 had the state not received a one-time disbursement of \$344 million under the Reed Act.

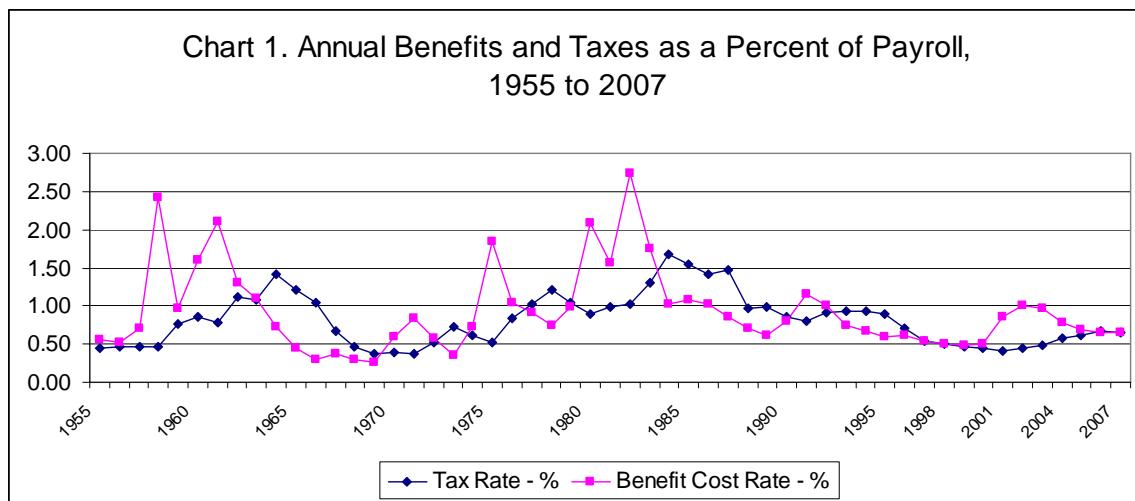
For any UI program that experiences a major loss of reserves, the underlying explanation is that benefit outlays have exceed tax revenues. To provide some historical perspective on Ohio's recent experience, annual UI benefits and taxes have been traced over the 53 years between 1955 and 2007. Benefit payouts and tax receipts were measured relative to total payroll.

Chart 1 displays both series. The volatility of benefit payouts is clearly illustrated with recession years such as 1958, 1961, 1975, 1980, 1982 and 1991-92, and 2002-03 having obvious high payout rates. Note however that the years with payout rates exceeding 1.5 percent of payroll all occurred before 1985. Payout rates during the past two recessions have not matched the high levels of the earlier recessions.

A general pattern of payouts exceeding revenues during recessions is obvious in Chart 1. Note also how effective tax rates (tax receipts as a percent of payroll) then increase following recessions and exceed the benefit payout rate during subsequent post-recession years. This is most obvious during 1964-1967, 1984-1987 and again during 1993-1996. The pattern is anticipated in a UI program with a trust fund and experience rating. Trust funds decrease during recessions and then are restored during post-recession years as taxes increase in response to the trust fund drawdown.

Note in Chart 1, however, that the effective UI tax rate did not increase much following the increase in payouts of 2001-2003. In fact, the tax rate is consistently below

the benefit payout rate for all years between 2001 and 2005. This is precisely the period when the state trust fund experienced most of its loss of reserves. Finally, the chart also clearly shows that the UI tax rate has been low in recent years. No effective tax rate in the present decade has exceeded 0.70 percent of payroll while effective tax rates of 0.90 percent or higher are observed during the four years 1992 to 1995.



As a second way to summarize the experiences of the most recent years, the annual tax rates and benefit payout rates were each ranked from top to bottom over the same 53-year period. The benefit year with the highest rank was 1982 when benefits represented 2.74 percent of payroll. Between 2000 and 2007 the average ranking for the eight annual benefit payout rates was 29.3 or just slightly below the median ranking of 27. For taxes, in contrast, the average ranking during 2000-2007 was much lower at 40.0. The loss of reserves occurred in a period when payouts were slightly below-average but UI taxes were even further below-average. A major reason for the loss of reserves has been the sluggish response of UI taxes following the recession of 2001.

The slow recovery of employment following the recession of 2001 and the associated failure of unemployment to decrease in line with the national pattern have also contributed to the decrease in the UI trust fund. However, the benefit payout rate during 2004-2007 averaged 0.69 percent, only slightly higher than 0.65 percent during the recovery period 1993-1996. In contrast, the average tax rates during these two time periods were 0.87 percent during 1993-1996 and 0.63 percent during 2004-2007. Most of

the explanation for the loss of reserves since 2000 is due to the limited response of UI taxes and not a high the rate of benefit payouts.

Because of the low current level of the UI trust fund, Ohio may need loans from the U.S. Treasury during 2008 or 2009. It is likely that policy actions to raise the trust fund balance will involve both tax increases and benefit reductions. Based on the preceding discussion it would seem that most of the adjustments should involve enhancements to revenue since the benefit side of Ohio's program has not undergone important changes in recent years.¹ Benefit payments have grown as the economy has grown, but taxes have lagged economic growth. The next section discusses UI tax revenues and the concept of tax capacity. The following section then discusses changes that would enhance the financial position of Ohio's UI program.

Tax Capacity in Ohio

Tax capacity is the maximum potential revenue that can be derived based on currently operative tax statutes. It is the product of three factors: 1) total payroll of taxable covered employers, 2) the taxable wage proportion and 3) the maximum potential effective tax rate on taxable wages. The product of the three factors determines total potential tax revenue implied by the current UI tax laws.²

The maximum potential tax rate is difficult to specify precisely. In Ohio, the combined tax rate is the sum of three tax rates: the maximum potential tax rate from the basic experience rating tax schedule, the mutualized tax rate and the maximum potential minimum safe level (MSL) tax rate. Under current statutes, the mutualized tax has a maximum rate of 0.5 percent. The problem arises in specifying the maximum rate for the other two taxes. The maximum effective tax rate for experience rated taxes depends heavily upon the distribution of employers and taxable payroll across the individual

¹ An analysis of UI benefits in Ohio is given in a report on benefits prepared under the present project. See Wayne Vroman, "Analysis of UI Benefits in Ohio," report to the Ohio Department of Jobs and Family Services, (May 20, 2008). Table 2 of this report documents the stability of the recipiency rate (beneficiaries as a proportion of unemployment) and the replacement rate (weekly benefits as a proportion of weekly wages) in Ohio during the past three decades.

² The discussion will focus on experience rated employers. While there are also revenues from new employers and employers subject to penalty tax rates, they are of small importance in Ohio, e.g., 3.3 percent of total revenues in the ETA-204 data for rate year 2007.

reserve ratio intervals. The basic tax schedule has tax rates that range from a minimum of 0.1 percent to a maximum of 6.5 percent. As an increased share of taxable wages is situated among employers with low and negative balances, the average tax rate will be higher. The maximum MSL tax rate depends upon the distribution of employers across the detailed tax rate intervals, the mutualized tax rate and the recent average benefit payout rate. Consequently, the maximum potential effective tax rates for these two experience-rated components are not precisely defined. Recent experiences with high payout rates would influence both maximums.³

Thus while the taxable wage proportion and taxable payroll are clearly defined, the maximum combined tax rate has some inherent ambiguity. Despite this ambiguity, Ohio needs to enhance the tax capacity of its UI program. This can be achieved through increases in the taxable wage proportion or through an increase in one or more of the three tax rates identified above.

Recommended Changes to Improve Solvency in the Short Run

Because Ohio faces the short-term likelihood of borrowing from the U.S. Treasury during 2008-2009, there is an immediate need to improve the UI program's fiscal balance through increased taxes and (perhaps) reduced benefits. Besides this immediate short-run need, Ohio also needs to improve the long-run solvency of its program to prevent a repetition of the present situation in future years. In recognition of these two aspects of the present situation, the recommendations of this report fall into two categories. First, the report makes two recommendations to address the immediate short-run situation: raise the taxable wage base and freeze the maximum weekly benefit. Second, it makes two recommendations to improve solvency in the long run. Ohio should index the tax base to growth in average covered wages and change the assignment of mutualized and MSL taxes. The mutualized tax should be used to defray mutualized costs while all of the MSL tax should be dedicated for deposit into individual employer

³ The statement assumes tax rates are fixed for each individual tax rate interval between the highest rate (-20 percent of taxable payroll and lower) and the lowest (plus 14 percent of taxable payroll and higher) and for all intermediate intervals. The maximum potential tax rate could also change if the rates within the intervals were altered or if the end points of the tax schedule (currently reserve ratios of minus 20 percent and plus 14 percent) were extended.

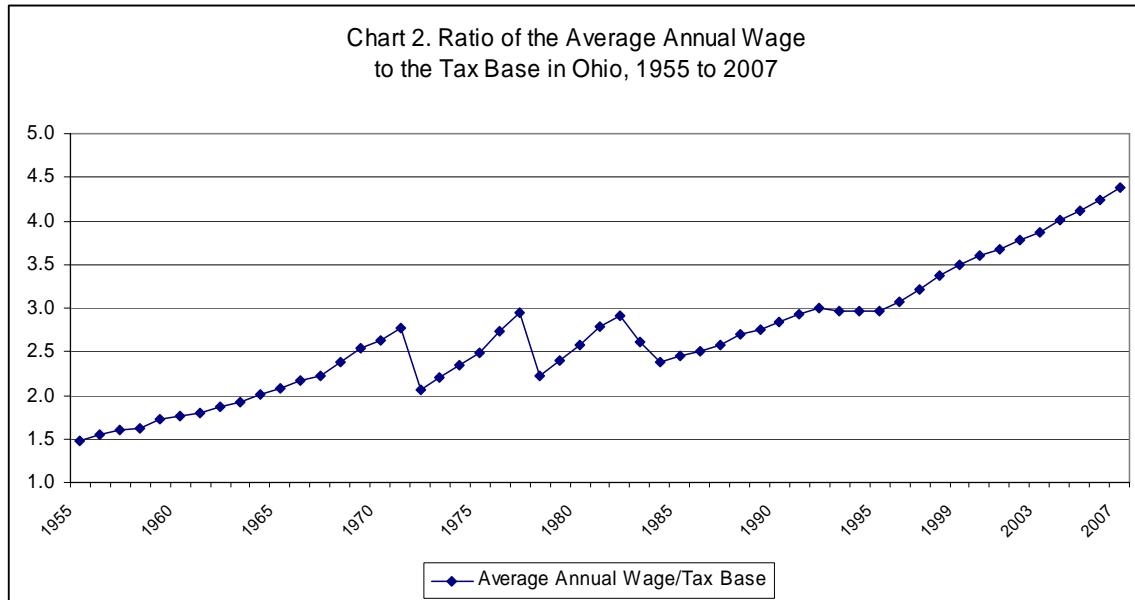
accounts. Third, the report makes three recommendations to change access to benefits. The three are to reduce the restrictiveness of monetary eligibility requirements, eliminate dependents' benefits and broaden the beneficiary base by adopting short-time compensation (STC or worksharing) and self-employment assistance (SEA) programs. Among the seven recommended changes, the recommended tax changes are of higher priority than the changes in benefits.

Underlying the current financial problem confronting Ohio's UI program is an imbalance between the revenue and the benefits sides of the program. Benefits grow automatically with growth in the Ohio economy while revenues lag economic growth. Currently the maximum weekly benefit is indexed to average wages in covered employment while the taxable wage base has been fixed at \$9,000 since 1995. Raising and indexing the taxable wage base would make a substantial contribution in achieving a better balance between tax revenues and benefit payments in the future.

The taxable wage proportion

The taxable wage proportion in a given year is determined by the ratio of the tax base (currently \$9,000 per worker) to average earnings in covered employment. In Ohio, the tax base has grown more slowly than average annual wages. Chart 2 vividly illustrates this slow growth by plotting the ratio of average wages to the tax base from 1955 to 2007. Prior to 1972 the tax base was \$3,000. Note in Chart 2 how the ratio of average wages to the tax base increased steadily from 1.47 in 1957 to 2.77 in 1971. The sawtooth pattern with three sharp decreases between 1972 and 1984 identifies years when the tax base increased, reaching \$8000 in 1984. Since 1984 there has been a steady increase in the average wage to tax base ratio, interrupted only between 1992 and 1995 by four annual increments of \$250 in the tax base. By 2007, the ratio had increased to 4.4, the highest ratio in the chart. Absent a change in the tax base, this ratio will continue to increase in 2008 and beyond. UI taxes in 2007 were levied on roughly one fourth of total payroll, the lowest taxable wage proportion since the program was established.

Note in Chart 2 that the average annual wage/tax base ratio remained stable during 1992-1995 as annual increases in the tax base almost exactly matched the increase in average money wages. The four year average during these years was 2.98. During these same years, the taxable wage proportion was stable with an average of 0.342.



The average annual wage paid by taxable employers in 2008 will be about \$41,000. To achieve an average annual wage/tax base ratio of 2.97 in 2008 implies a tax base of \$13,800, or \$4,800 higher than the current tax base of \$9,000. The tax base could be restored to its relative level of 1991-1995 through several consecutive years of \$1,000 increments. If this were enacted, the taxable wage proportion would increase to about its 1991-1995 level of 0.342. Since the taxable wage proportion for 2008 as projected by the simulation model will be 0.248, raising the tax base to \$14,000 would increase tax capacity by 35-40 percent when compared to tax capacity in 2008.

Recommendation 1. Increase the taxable wage base in 2009

An increase in the taxable wage base would substantially strengthen the ability of the Ohio UI program to restore its reserve position and to withstand drawdowns in future recessions. In short, increasing the tax base will enhance tax capacity in Ohio. Larger increases in the tax base would yield larger increments to future revenues. In simulations with the model developed for the current project, increases of \$1,000, \$2,000 and \$3,000 in 2009 (with no changes in tax rates) would respectively yield revenue increases of \$83 million, \$166 million and \$250 million. Increases of this scale would certainly reduce the likelihood of borrowing in 2009 and later years.

Although benefit payments have not shown unusual growth in the present decade, it is possible that legislation to improve the trust fund's short term position will include some type of restriction on future benefits. One possible change would be to temporarily freeze the maximum weekly benefit. A three year freeze during 2009-2011 would reduce benefit outlays by \$143 million over the three years. Freezing the maximum benefit would yield a pattern of increasing savings during the three years with annual savings estimated by simulation model being \$25 million in 2009, \$49 million in 2010 and \$69 million in 2011. The maximum for a single person in 2011 would still be \$365 rather than \$400 or 8.75 percent lower than projected under current indexation arrangements.

Recommendation 2. Freeze the maximum weekly benefit during 2009-2011

A benefit freeze during 2009-2011 would impose hardships on some workers with high weekly benefits. Micro data from 2004 indicate that about one quarter of recipients across the three classes of beneficiaries (single persons, those with one or two dependents and those with three or more dependents) received the maximum benefit. Thus the hardships caused by a freeze would be felt by a measurable share of claimants, but three quarters of recipients would be unaffected.

Ohio operated with a freeze during the 1980s with the maximum frozen at \$147 from 1982 to 1987. After the freeze was ended, maximum benefits were increased such that they were eventually restored to the levels implied by pre-freeze indexation provisions. A similar catch-up could be implemented during 2012 and 2013 such that the maximum in 2014 would be the same as it would have been absent a freeze. Simulations with the model suggest the maximum for a single claimant in 2014 would be \$440.

Implementation of recommendations 1 and 2 would improve the annual trust fund balance by a substantial amount in 2009 and later years. An increase in the tax base of \$2,000 in 2009, coupled with a benefit freeze, would increase the 2009 ending balance by \$191 million. Rather than ending the year 2009 with a balance of about -\$200 million, the ending balance would likely be close to zero. Given the uncertainties of the present economic environment, projecting future balances is extremely risky. The data from June

2008 show higher benefits and lower tax revenue than projected earlier this year. A continuation of the June 2008 patterns in benefits and taxes would lead to even more pessimistic projections of the trust fund balance in 2008 and 2009 than at present.

Recommended Changes to Improve Solvency in the Long Run

While the preceding two recommendations would help to prevent borrowing in the short run, they do not fully address the long-run imbalance in program funding that is apparent. The next two recommendations address the issue of long run fiscal balance.

Recommendation 3. Link Changes in the Taxable Wage Base to Growth in Average Wages

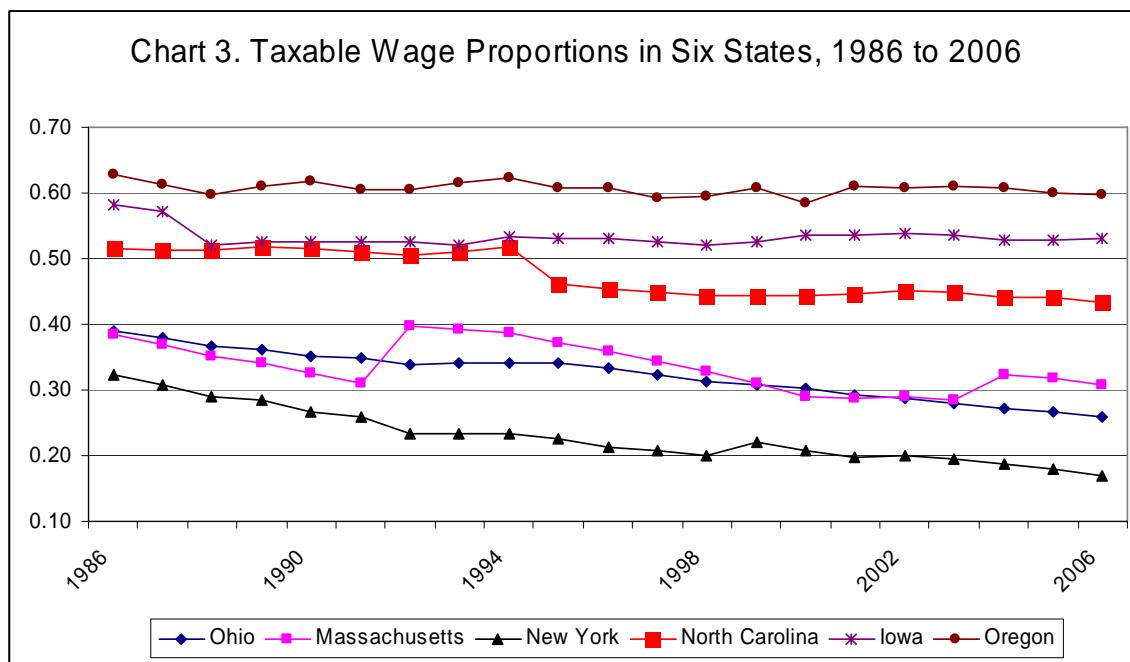
Increasing the tax base is an effective way to increase tax capacity because it increases the taxable wage proportion. For a given increase, however, its effect will be eroded in subsequent years unless the tax base is periodically raised. The easiest way to ensure subsequent increases is to tie (index) the tax base to average wages in covered employment. Under indexation, the tax base increases automatically every year with the size of the increment reflecting recent increases in average wages.

Sixteen states have UI programs with indexed tax bases. All 16 have had indexation arrangements for more than 20 years. Indexation has helped maintain solvency in these states. During the two most recent recessions (1991 and 2001) there were 16 different episodes of state UI programs needing loans from the U.S. Treasury. Twelve different states were involved as four states borrowed during both recessions (Massachusetts, Michigan, Missouri and New York). Only two episodes involved states with indexed tax bases (Minnesota and North Carolina after the 2001 recession) while 14 loans went to states with fixed tax bases, including the four that borrowed during both recessions. For the two recessions, the crude probabilities of borrowing were 2 of 32 or 0.062 for the indexed states versus 14 of 70 or 0.200 for the non-indexed states.⁴

⁴ With 51 programs and two recessions, there were potentially 102 borrowing situations.

During the past two recessions, states with indexed tax bases were roughly one third as likely to borrow when compared to non-indexed states. With indexation, the tax base increases automatically, stabilizes the taxable wage proportion and helps prevent erosion of tax capacity as has occurred in Ohio since 1995.

Chart 3 illustrates the experiences of six states during the period 1986 to 2006. The tax bases in Oregon, Iowa and North Carolina are indexed to average wages in covered employment with indexation ratios of 0.800, 0.667 and 0.500 respectively. Note the stability of the taxable wage proportions. The average proportions for these 21 years were respectively 0.606, 0.533 and 0.475. The only large changes in the taxable wage proportions for these three states were decreases in 1988 in Iowa and 1995 in North Carolina. In Iowa, the decrease in 1988 removed temporary increases in the tax base undertaken for solvency considerations. In North Carolina, the indexation ratio was reduced from 0.60 to 0.50 in 1995. Besides these two reductions, the taxable wage proportions during these years were stable in the three indexed states.



The three non-indexed states present a sharp contrast. For Ohio, Massachusetts and New York, the predominant direction of change has been for decreases in the taxable wage proportion. In Massachusetts, the taxable wage proportion increased in 1992 and in

2004, both years when the tax base was increased as a component of solvency legislation.⁵ The New York tax base remained at \$7,000 until 1999 when it increased to \$8,500 and has remained at \$8,500 through 2008. Over the 21 years, the taxable wage proportion in New York decreased from 0.322 to 0.169. As discussed earlier, Ohio's tax base during these years only increased during 1992-1995. Thus the taxable wage proportion decreased from 0.390 in 1986 to 0.260 in 2006.

Chart 3 also vividly illustrates an important related point about the linkage between indexation and the taxable wage proportion. States with indexed taxable wage bases consistently exhibit higher taxable wage proportion than non-indexed states. All 63 data points for the three indexed programs in Chart 3 exceed 0.40 while not one of the 63 for the three non-indexed programs is as high as 0.40. While discretionary increases in tax bases could occur in states without indexation, this rarely occurs in practice. A major impetus for raising the tax base in non-indexed states is the onset of a financing crisis. Illinois, Massachusetts and Missouri did so following the recession of 2001. Even the presence of a financing crisis has not been sufficient in New York to provoke an increase in its taxable wage base. New York borrowed from the Treasury in every year between 2002 and 2008, but its tax base has remained at \$8,500.

In short, Ohio should index its taxable wage base. A good time to implement indexation would be in the year that follows the next increase in the taxable wage base. If the base is increased in 2009, indexation could be implemented as soon as 2010.

Recommendation 4. Redirect Revenues from the Mutualized Tax and the MSL Tax to their Original Intended Uses

In recent years the largest charges against Ohio's mutualized account have been noncharged benefits and charges against closed accounts. These and other charges have been covered by three sources of revenue: the mutualized tax (in years when the tax has been activated), half of the revenue from the minimum safe level (MSL) tax and interest earnings from the trust balance held at the U.S. Treasury. With the decrease in the trust

⁵ The Massachusetts tax base increased from \$7,000 in 1991 to \$10,800 in 1992. The base increased from \$10,800 in 2003 to \$14,000 in 2004.

fund balance, interest income has become a small component of total credits into the mutualized account. The mutualized tax rate is determined by the balance in the mutualized account on June 30th. Large credits from half of MSL taxes have been and will continue to be the main source of revenue for the mutualized account under current arrangements. The mutualized tax rate has not exceeded 0.20 percent since 1994.

The UI tax system would be more transparent if a mutualized tax were levied each year, and its proceeds were used consistently to defray mutualized charges such as noncharged benefits and charges against closed accounts. Interest income from the trust fund could continue being used to defray mutualized charges, but this will be of small importance over the next few years given the present low level of the trust fund.

Charges against the mutualized account have ranged between \$200 and \$300 million in recent years. If the mutualized tax were to be the primary revenue source to cover mutualized charges, it would have to have a maximum authorized tax rate higher than its current maximum of 0.50 percent. A maximum in the 0.70-0.80 percent range would be sufficient to meet unusually large mutualized charges such as the \$360 million realized in 2002.

The advantage of using an annual mutualized tax to defray the bulk of mutualized charges would be that all of the MSL tax could then flow directly into individual employer accounts and speed the rebuilding of their accounts following a recession.

This proposed redirection of the mutualized and MSL revenue streams would accomplish two things. 1) It would direct mutualized and MSL tax revenue to their respective intended uses, e.g., mutualized taxes to cover the costs of mutualized charges and MSL taxes to rebuild individual employer account balances. 2) It would speed the recovery of employer account balances following a recession because all of MSL taxes would flow into individual employer accounts. Combined, these two changes would cause taxes to increase more rapidly following a recession and foster a faster recovery of the net trust fund balance. Implementing the changes would also increase the transparency of the UI tax system in Ohio as revenue from these two taxes would be directed towards its original intended use.

Other Recommended Changes

Recommendation 5. Ease the Requirement for Monetary Eligibility

Ohio has one of the most stringent requirements for monetary eligibility of all UI programs. The minimum requirement is at least twenty weeks of employment in the base period at an average weekly wage of 27.5 percent or more of the statewide average weekly wage. In 2008 this weekly wage must average \$206. Thus someone who worked 50 weeks with an average weekly wage of \$200 would be monetarily ineligible despite having earnings of \$10,000 in the base period.

Federal legislation of 2007 will bring major increases in the federal minimum wage. It will increase from its present \$5.85 to \$6.55 on July 24th and to \$7.25 in late July 2009. An alternative to the current monetary requirement would be to require 20 weeks of employment with weekly earnings of at least 20 times the federal minimum hourly wage. This would be \$131 during January-July 2009 and \$145 after the minimum wage increases in late July 2009.⁶

The timing of such a change could be done with an eye towards the balance in the UI trust fund. Delaying this change until the present financial situation improves would probably garner more political support than making the change effective January 1st of next year. Irrespective of the date of implementing this change, it should be acknowledged that Ohio's monetary eligibility requirement is high, and it undoubtedly prevents unemployed low-wage workers from receiving unemployment benefits.

Recommendation 6. Eliminate Dependents' Benefits

Ohio pays dependents' benefits that can exceed benefits for a single claimant by 35 percent. The maximum weekly benefit in 2008 is \$365 for a single person but \$493 for a person with three or more dependents. To receive the higher weekly benefit,

⁶ If the requirement was to work 25 hours per week, the weekly requirements would be \$164 during January-July 2009 and \$181 after July 2009.

however, the claimant must have proportionately higher earnings as the maximum is effectively 48 percent of past average weekly wages for all three dependency groups.

In micro data from 2004, about one quarter of UI recipients were paid the maximum weekly benefit. The majority received the maximum for a single person. Because of the structure of these payments, added benefits related to dependency do not go to low wage workers and their families. To receive higher payments the claimant must have had higher earnings in the base period.

Administering dependents' benefits causes some added administrative costs related to verifying the accuracy of dependency claims. There are also some problems in recovering overpayments related to claims of dependency.

One way to eliminate dependents' benefits would operate a phase-out over a period of some eight to ten years. The maximum for claimant classes B and C (persons with dependents) could be frozen while the maximum for a single person could continue to increase under current indexation arrangements. A phase-out could be accomplished more quickly if implemented at the end of temporary benefit freeze as recommended above. A restored maximum for a single person would then surpass the maxima for dependents' benefits as it was restored to its appropriate level.

While ending dependents' benefits would cause greater hardship for some claimants, it would also realize savings for the UI program. Simulations with micro data from 2004 suggested that savings of 4.7 percent per year would be realized after the phase-out was fully implemented.

Recommendation 7. Consider Implementing Short Time Compensation (STC) and Self-Employment Assistance (SEA) Programs

Several states currently administer STC and/or SEA programs. Experiences across these states uniformly indicate that these programs are small. Typically less than one percent of claimants participate in either STC or SEA. However, once established, these programs have persisted.

STC (or worksharing) programs offer employers an alternative to layoffs in making workforce adjustment during a recession. Workers can be placed on short

schedules, e.g., four day schedules, allowing more workers to be retained. Paying UI benefits for the fifth day helps to maintain worker income as well as preventing layoffs. Those retained under worksharing are usually persons with low seniority. Preventing layoffs can help promote long-term employment relationships.

SEA programs typically serve even fewer persons than STC programs. However, promotion of self-employment through the UI program is favored by some experienced workers who otherwise might not try to establish their own businesses.

The main value of STC and SEA programs lies in offering a broader range of services to claimants than offered by a traditional UI program. STC would also be preferred by some employers as a means of retaining valued employees during a recession. The added costs attributable to STC and SEA would be trivial as participants in both programs would not have larger potential entitlements compared to their eligibility for regular UI benefits.

These final three recommendations have offsetting effects on total benefit payments. On balance, the savings to be realized from eliminating dependents' benefits would exceed increased payouts caused by easier monetary eligibility requirements. Implementing STC and SEA would have no measurable effect on benefit payouts. The net effect of these changes would be to increase recipiency in Ohio without increasing total benefit payments.