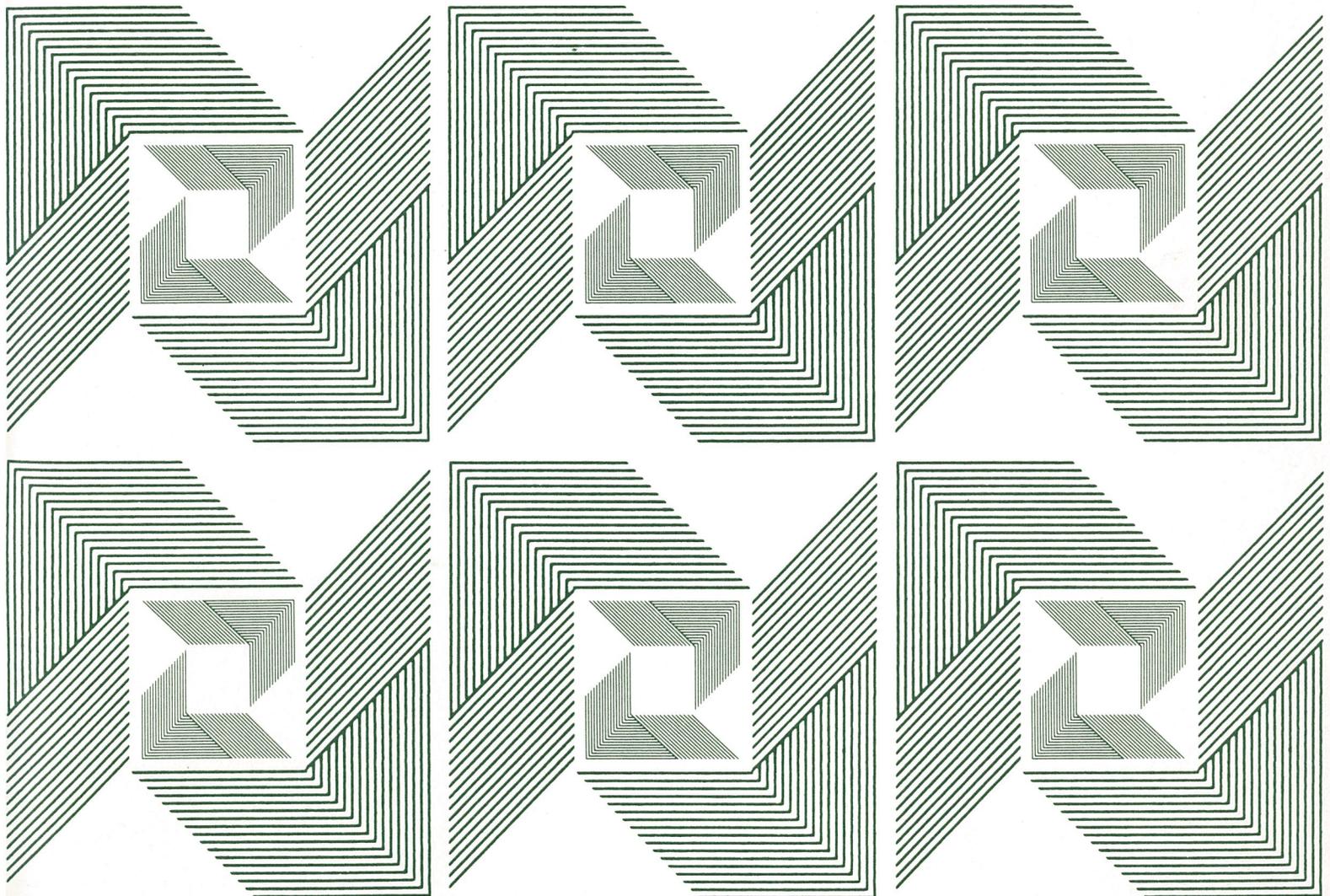


REPORT NO. 83-12
FEBRUARY 1983

STUDY OF THE FINANCING OF THE UNEMPLOYMENT COMPENSATION FUND OF THE STATE OF HAWAII

CONDUCTED BY: PEAT MARWICK MITCHELL & CO.
A REPORT TO THE LEGISLATURE OF THE STATE OF HAWAII



SUBMITTED BY THE LEGISLATIVE AUDITOR OF THE STATE OF HAWAII

THE OFFICE OF THE LEGISLATIVE AUDITOR

The office of the legislative auditor is a public agency attached to the Hawaii State legislature. It is established by Article VII, Section 10, of the Constitution of the State of Hawaii. The expenses of the office are financed through appropriations made by the legislature.

The primary function of this office is to strengthen the legislature's capabilities in making rational decisions with respect to authorizing public programs, setting program levels, and establishing fiscal policies and in conducting an effective review and appraisal of the performance of public agencies.

The office of the legislative auditor endeavors to fulfill this responsibility by carrying on the following activities.

1. Conducting examinations and tests of state agencies' planning, programming, and budgeting processes to determine the quality of these processes and thus the pertinence of the actions requested of the legislature by these agencies.
2. Conducting examinations and tests of state agencies' implementation processes to determine whether the laws, policies, and programs of the State are being carried out in an effective, efficient, and economical manner.
3. Conducting systematic and periodic examinations of all financial statements prepared by and for all state and county agencies to attest to their substantial accuracy and reliability.
4. Conducting tests of all internal control systems of state and local agencies to ensure that such systems are properly designed to safeguard the agencies' assets against loss from waste, fraud, error, etc.; to ensure the legality, accuracy, and reliability of the agencies' financial transaction records and statements; to promote efficient operations; and to encourage adherence to prescribed management policies.

5. Conducting special studies and investigations as may be directed by the legislature.

Hawaii's laws provide the legislative auditor with broad powers to examine and inspect all books, records, statements, documents, and all financial affairs of every state and local agency. However, the office exercises no control functions and is restricted to reviewing, evaluating, and reporting its findings and recommendations to the legislature and the governor. The independent, objective, and impartial manner in which the legislative auditor is required to conduct his examinations provides the basis for placing reliance on his findings and recommendations.



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**Conducted by
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A Report to the Legislature of the State of Hawaii

**Submitted by the
Legislative Auditor of the State of Hawaii**

**Report No. 83-12
February 1983**

FOREWORD

In the 1982 legislative session, with the recession continuing, unemployment rates high, and a growing number of jurisdictions unable to pay for jobless benefits except through loans from the federal government, the Hawaii State Legislature adopted House Concurrent Resolution No. 103, H. D. 1. The resolution requested our office to review the administration and adequacy of the state's unemployment compensation fund and to determine whether there should be any changes in the law.

Economic conditions have not changed much since the 1982 session and, therefore, the circumstances under which the study was conducted and this report was prepared are much the same as when the study was requested by the Legislature. The times are still relatively bad, and many states have their backs to the wall in trying to cope with the magnitude of paying for unemployment benefits. The State of Hawaii is fortunate in that even as it follows early warning signals to study the problem of financing jobless benefits, its unemployment compensation fund is solvent.

We assigned the task of studying the adequacy of the unemployment compensation fund and its financing to the CPA firm Peat, Marwick, Mitchell & Co. The reader who wishes to obtain an initial understanding of the issues and the outcome of the consultants' examination should refer to the overview of the study which is presented in the pages immediately following this foreword. More details and technical information are to be found in the body of the report.

We acknowledge with appreciation the assistance which was provided to our office and the consultants by the Department of Labor and Industrial Relations, other public agencies and numerous organizations and individuals in the private sector who supplied information and presented their views during the course of the study.

Clinton T. Tanimura
Legislative Auditor
State of Hawaii

OVERVIEW OF THE STUDY BY THE LEGISLATIVE AUDITOR

BACKGROUND

The unemployment compensation program in America originated as part of the Social Security Act of 1935. Basically, the program involves: (1) the collection of contributions from employers to finance the payment of benefits; and (2) the payment of benefits to eligible persons who are unemployed. It is the primary program of aid to unemployed workers and covers over 95% of all workers in this country.

The administration of the program and benefits paid to unemployed workers are financed almost entirely by a tax on employers. The program is implemented through individual state programs that operate under broad federal guidelines. Within some restrictions, the states have a free hand in designing their programs and have general discretion in determining benefit amounts and duration, eligibility and disqualification rules and taxing methods and tax rates.

To finance the program, employers are required to pay an unemployment compensation tax to the federal government as well as a tax to the state. All states use a form of "experience rating" in setting their tax rates. "Experience rating" involves classifying employers based upon some measure of their unemployment record or experience. Generally, employers with better-than-average experience qualify for lower tax rates. Those with poorer experience pay higher rates.

THE BASIC ISSUES AND FINDINGS

Adequacy of the Fund

While a number of aspects were covered in the study, two basic issues constituted the most important elements for analysis in the study. The first issue is whether the fund balance in the unemployment compensation fund is adequate to ensure the solvency of the program or whether it is excessive. The notion that the fund balance may be excessive and that employers were being taxed too much was heard in the 1982 session when it was learned that the fund balance was in the neighborhood of \$100 million.

The consultants found that the State's fund balance is adequate to ensure program solvency but that it is not excessive. The fund is projected to remain solvent even if the State were to be presented with a "worst case" unemployment scenario for the next five years. At the same time, the consultants do not consider the fund balance to be excessive. Against standards recommended by the U. S. Department of Labor, which believes that a state's fund balance is adequate when it is large enough to cover a minimum of 18 months of recession-level benefits, Hawaii's fund balance does not measure up to that level of adequacy, but its relative position of being able to have its balance cover benefits for about a year is better than most states.

Allocating the Costs of Unemployment

The second fundamental issue analyzed is whether the system, to the extent possible, fairly allocates the costs of unemployment. The consultants found that there currently exists a high degree of employers with good unemployment

experience subsidizing employers with poor unemployment experience. In 1981, the benefits paid to the former employees of negative reserve employers (those with the worst experiences) were more than double the amount that these employers paid in taxes. Among industries, agriculture and construction appear to be the most consistently subsidized, with benefits exceeding taxes in agriculture in every year in the past 18 years and with the same occurring in construction in all but four years.

The cause of the subsidization by good experience employers is the present tax structure which sets a maximum tax rate that is too low to recoup program costs generated by employers with poor unemployment experience. The maximum rate is now 4.5%, whereas the consultants believe it should be around 7.5%. A higher maximum rate would reduce the level of subsidization and contribute towards a more accurate allocation of the costs of unemployment.

RECOMMENDATION

The consultants do not believe any major change should be made in the basic financing system for unemployment compensation but they do advocate the increase of the maximum basic tax rate to 7.5% so as to reduce the subsidization of poor experience employers by good experience employers.

STUDY OF THE FINANCING
OF THE UNEMPLOYMENT COMPENSATION
FUND OF THE STATE OF HAWAII

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PART I
BACKGROUND

Chapter 1

UNEMPLOYMENT COMPENSATION

The program of unemployment compensation (or unemployment insurance) in the United States today originated as part of the Social Security Act of 1935. It is the primary program of aid to the unemployed worker and covers over 95% of all workers in the United States.

OBJECTIVES

According to Haber and Murray, the major objective of unemployment compensation is ". . . to alleviate the hardships that result from the loss of wage income during unemployment."¹ Other objectives include: (1) stabilizing the economy through the maintenance of purchasing power; (2) offering an incentive to employers to stabilize employment; and (3) achieving a proper allocation of the costs of unemployment. The latter two objectives are accomplished through experience rating - the determination of tax rates based upon experience with unemployment.

PROGRAM FEATURES

Some of the unique features of the unemployment compensation program are as follows:

¹William Haber and Merrill G. Murray, Unemployment Insurance in the American Economy, Richard D. Irwin, Inc., June 1966, page 26.

Qualification for benefits. Basically, the right to benefits compensation is established not by need, but by previous employment. In this respect, unemployment compensation differs from other income maintenance programs.

Employer financing. The administration of the program and benefits paid to unemployed workers are financed almost entirely by a tax on employers. In only three states are employees required to make tax payments, and in each case, only nominal rates are imposed. Other sources of program revenue include federal revenues, investment income earned on surplus monies, and interest and penalties on delinquent payments.

Federal-state system. The unemployment compensation program is implemented through individual state programs that operate within broad federal guidelines. Within some restrictions, the states have a free hand in designing their programs and have general discretion in determining:

- Benefit amounts and duration;
- Eligibility and disqualification rules; and
- Taxing methods and tax rates.

The purpose of this is latitude to allow state legislatures and administrations to structure programs that are best suited to the conditions and circumstances within their states. As a result, there is wide variation among state programs, although each program does adhere to certain basic precepts.

BENEFITS

Several types of benefits are currently or have been provided by the unemployment compensation program. All states have basic benefit provisions and starting in the early 1960s, these have been expanded frequently by federally mandated additional benefits. With the exception of extended benefits, these additions have been temporary in nature and fully financed by the federal government. All benefits are paid on a weekly basis and amounts vary by claimant depending upon wages earned.

Currently the following types of benefits are provided:

Regular benefits. These are the normal benefits paid by state programs. Amount and duration provisions vary by state, although the maximum duration is generally 26 weeks.

Extended benefits. First paid in 1961, these federally mandated benefits were established permanently on a nationwide basis in 1972. Benefits are provided for up to 13 additional weeks to claimants who have exhausted their regular benefits. Benefit costs are shared equally by the states and the federal government, and payment is triggered by high rates of unemployment at the state level. A national trigger was also provided originally but was eliminated in 1981.

Federal supplemental compensation. Enacted in 1982, this program provides up to 10 weeks of benefits in addition to regular and extended benefits. The program will expire in 1983 and is financed entirely by the federal government.

In addition to the above, additional extended benefits and supplemental benefits were provided at various times from 1972 to 1978. Financed entirely by the federal government, these benefit provisions were most liberal from 1975 to 1977, when claimants were entitled to up to a maximum of 65 weeks of regular, extended and supplemental benefits.

Chapter 2

FINANCING

One of the unique features of the unemployment compensation program is an almost total reliance upon employer financing. To finance the system, employers are required to pay two unemployment compensation taxes: a federal tax, called the "FUTA" (for Federal Unemployment Tax Act) tax; and a state tax, called the "SUTA" (for State Unemployment Tax Act) tax. The FUTA tax is used primarily to finance federal and state administration of the program, and to pay the federal share of extended benefits. The SUTA tax is used exclusively for the payment of benefits. The disposition of FUTA tax revenues is the responsibility of the federal government, specifically the Department of Labor. The individual states alone have authority over the disposition of SUTA tax revenues.

ROLE OF THE U. S. TREASURY

All FUTA and SUTA tax receipts collected are required to be kept on deposit until needed with the U. S. Treasury in the Unemployment Trust Fund. The federal government maintains three accounts in the Trust Fund, each with a separate purpose. Each state also maintains a separate account in the Trust Fund.

All federal and state monies on deposit in the Trust Fund are invested in obligations of the U. S. government and earn interest. Although the U. S. Treasury has sole investment authority over the monies on deposit, the

custodial functions it performs should not be confused with the exclusive authority each of the states and the Department of Labor have over the disposition of the balances of their respective accounts.

FEDERAL ADVANCES

The primary source of the monies to pay benefit payments is the SUTA tax. Another source that is intended to be temporary in duration is federal advances. These advances are made to states that, during periods when benefit payments exceed SUTA tax receipts, have exhausted their Trust Fund balances. In the past, such advances were completely interest free. As of April 1, 1982 interest may be assessed if the advances are not repaid within established time limits. The federal government may also force repayment by reducing the allowable SUTA tax credit, unless certain requirements are met by borrowing states.

FUTA TAX

Currently the FUTA tax is assessed at a gross rate of 3.4% of the first \$6,000 (the federal "taxable wage base") paid to each employee by a covered employer. A credit of up to 2.7% is allowed, however, for any SUTA tax paid by the employer. In addition, employers may take the full credit even if the taxes they have paid are less than 2.7%, if their lower rate is due to a favorable experience with unemployment. As a consequence, all states currently use "experience rating" in determining SUTA tax rates, and the FUTA tax is actually paid at a net rate of only 0.7%.

The three Trust Fund accounts in which FUTA tax monies are maintained are the:

- Employment Security Administration Account;
- Extended Unemployment Compensation Account; and
- Federal Unemployment Account.

Employment Security Administration Account (ESAA). Two-thirds of the 0.7% FUTA tax (0.45%) is deposited into this account and is reserved for federal and state administration. This includes administration of:

- Unemployment compensation;
- Employment services;
- Labor market information; and
- Veterans employment services.

Up to 95% of the monies in this account may be appropriated annually to the states for administration. Up to 5% may be used for federal administration by the Department of Labor and the U. S. Treasury.

Extended Unemployment Compensation Account (EUCA). The remaining one-third of the 0.7% FUTA tax (.25%) is deposited into this account and is reserved to pay the federal portion (one-half) of current extended benefits. The monies are also designated to be used to repay advances made from federal general revenues to pay for the federal portion of extended benefits and the supplemental benefits paid during the recession of the mid-1970s.

Federal Unemployment Account (FUA). This account is known as the "loan fund" and is used to record federal advances made to states. Monies in excess of certain statutory limits from the ESAA and EUCA accounts are designated as the financing source for this account, although the predominant source of funds for loans in recent years has been federal general revenues.

SUTA TAX

The SUTA tax is levied by the states. There is a wide variation among the states regarding tax rates and taxable wage base, although certain basic federal requirements must be met. At a minimum, the taxable wage base used by the states should equal the federal taxable wage base of \$6,000. Also, the maximum experience-rated tax rate used should equal at least 2.7%. Both of these requirements are necessary to qualify for the full SUTA tax credit against the FUTA tax.

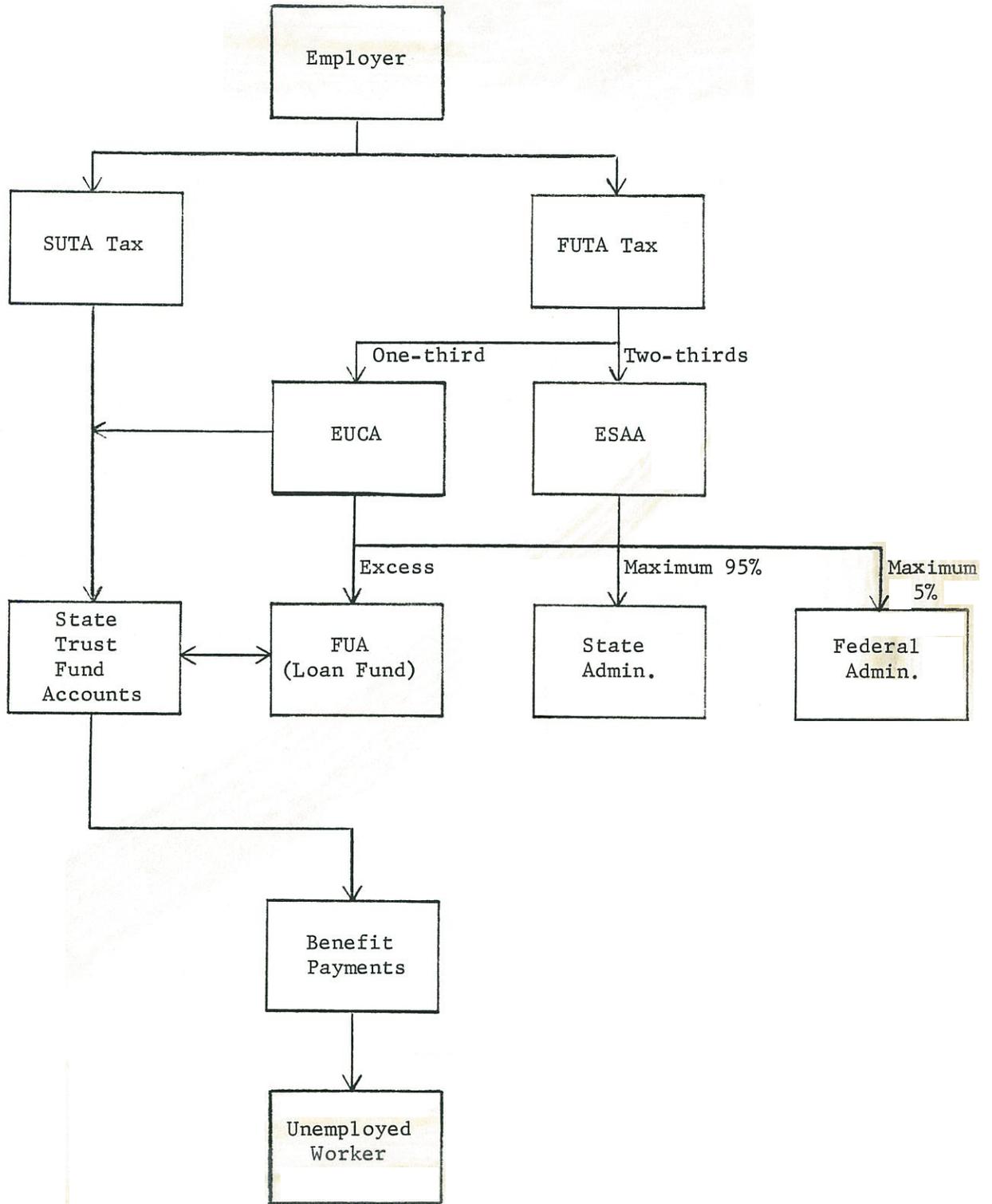
As noted, all surplus SUTA tax monies are kept on deposit in the Trust Fund. On a regular basis, monies are transferred to the states, subsequently to be used to make benefit payments.

SYSTEM OVERVIEW

An overview of the flow of monies and the Trust Fund accounts described above is presented at Exhibit 2-1.

Exhibit 2-1

UNEMPLOYMENT COMPENSATION PROGRAM:
REVENUE SOURCES, USES AND TRUST FUND ACCOUNTS



Source: Interstate Conference of Employment Security Agencies, Inc., "Financing the Employment Security System: A Primer on the Current Status and Prospects", June 1982.

Chapter 3

EXPERIENCE RATING

All state programs use a form of experience rating in setting SUTA tax rates. "Experience rating" involves classifying employers based upon some measure of unemployment incurred, the most commonly used measure being benefits paid to former employees. In its strictest application, experience rating requires that employers with similar unemployment experience pay taxes at similar rates and in amounts that equal the benefits paid to former employees. The preference for an experience-rated tax is derived from certain beneficial effects it possesses over a nonexperience-rated, flat-rate tax.

INCENTIVE EFFECT OF EXPERIENCE RATING

Probably the most often cited advantage of experience rating is that it gives employers an incentive to stabilize employment. This is based upon the concept of employer power.

Employers, it is reasoned, have the final authority over the decision to hire, retain or lay off workers. Making employers bear their proportionate share of the social costs of unemployment, therefore, will motivate them to minimize layoffs and retain workers for longer periods. The experience-rated tax thus provides an incentive for employers to stabilize employment.

This argument contains a certain degree of validity. It has a major weakness, however, in its basic assumption regarding employer power in that most of the costs of unemployment are not within the ability of individual employers to control. These costs are largely determined by external factors that include:

- The nature of the business and industry;
- The status of the local and national economy; and
- The ultimate duration of worker unemployment.

Because of these factors, the incentive value of an experience-rated tax is limited.

ALLOCATION OF RESOURCES EFFECT

A more far-reaching argument for experience rating is offered by Joseph M. Becker. Father Becker's views are presented in the following quote from his text Experience Rating in Unemployment Insurance: An Experiment in Competitive Socialism:¹

"The most basic advantage claimed for experience rating is that it accords with our society's choice of the free market as the major mechanism for the allocation of resources.

¹John Hopkins University Press, 1972, page 44.

"The case for this claim may be set out in the form of a loose sorites:
(1) As its main mechanism for the allocation of resources our society has chosen the free market. (2) The market works the more efficiently as market prices more accurately reflect the full costs of production. (3) The costs of production are reflected in market prices, the more fully as the unemployment tax is the more completely experience rated. (4) Thus experience rating accords with society's choice of the market as the main mechanism for the allocation of resources.

"The final step in the argument produces a fifth and crucial proposition:
(5) Since experience rating thus accords with society's fundamental economic choice, it occupies a position of presumptive favor. Although the presumption is rebuttable by specific evidence, in the absence of such evidence the allocation effect of experience rating enjoys the benefit of the doubt. To put this proposition in a slightly different form: When specific evidence of undesirability is not obtainable (the usual case), the desirability of the allocative effect of experience rating is assailable only by denying the first proposition of the sorites, which is almost universally accepted." (Emphasis added).

The "presumptive favor" of experience rating is the key concept introduced by Father Becker. To paraphrase, unless shown to be otherwise, experience rating must be assessed to be beneficial and preferred. Each deviation from complete experience rating, thus, must be supported by specific evidence of desirability.

Father Becker's argument has a strong theoretical appeal and acceptance of it lends substantial support to the concept of an experience-rated tax. This, in turn, requires the acceptance of a basic position regarding employer responsibility for unemployment.

EMPLOYER RESPONSIBILITY

Individual employer responsibility is defined to include responsibility for all costs of unemployment, controllable and uncontrollable. Thus, the moment that an employer hires a worker, he has accepted an obligation to pay, should the need occur, unemployment costs arising from that employment. Similarly, the decision of an employer to enter or remain in an industry or business that regularly produces high rates of unemployment is a decision also to accept responsibility for the costs of any unemployment incurred. Unemployment, thus, should be treated as a regular cost of doing business, not unlike other costs such as wages, materials and supplies.

Chapter 4

FINANCING METHODS

To determine SUTA tax rates, each of the states utilizes one of four basic financing methods (formulas). Each of the methods measures to some degree the experience of individual employers with unemployment and based upon this, assigns tax rates. Generally, employers with better-than-average experience qualify for lower tax rates, while those with poorer experience pay at higher rates. This is the essence of experience rating. The following is a description of each of the four basic methods, drawn substantially from the Department of Labor's Comparison of State Unemployment Insurance Laws.¹

Reserve ratio method. The reserve ratio is the earliest of the experience rating methods and continues to be the most popular. It is now used in 31 states and the District of Columbia. The system is essentially cost accounting. On each employer's record is entered the amount of his payroll, his contributions (taxes) and the benefits paid to his workers. The benefits are subtracted from the contributions, and the resulting balance is divided by payroll to determine the size of the balance in terms of the potential liability for benefits inherent in wage payments. The balance carried forward each year under the reserve method is ordinarily the difference between the employer's total contributions and the total benefits received by his workers since the program became effective.

¹U. S. Department of Labor, Employment and Training Administration, January 3, 1982 revision, page 2-5 to 2-7.

The employer must accumulate and maintain a specified reserve before his contribution rate is reduced. Rates are assigned according to a schedule of rates for specified ranges of reserve ratios: the higher the ratio, the lower the rate. The formula is designed to make sure that no employer will be granted a rate reduction unless over the years he contributes more to the program than his workers draw in benefits.

Benefit ratio method. The benefit ratio method also uses benefits as the measure of experience, but eliminates contributions from the formula and relates benefits directly to payrolls. The ratio of benefits to payrolls is the index for rate variation. The theory is that, if each employer pays a rate which approximates his benefit ratio, the program will be adequately financed.

Unlike the reserve ratio method, the benefit ratio method is geared to short-term experience. Generally, only the benefits paid in the most recent three years are used in the determination of the benefit ratios. The benefit ratio method is currently used by 12 states.

Benefit wage ratio method. The benefit wage ratio method is radically different from the reserve ratio and benefit ratio methods. It makes no attempt to measure all benefits paid to the workers of individual employers. The relative experience of employers is measured by the separations of workers which result in benefit payments, but the duration of their benefits is not a factor. The separations, weighted with the wages earned by the workers with each employer, are recorded on each employer's experience rating record as benefit wages. Only one separation per worker per year is recorded for any one employer. The index which is used to establish the relative experience of

employers is the proportion of each employer's payroll which is paid to those of his workers who become unemployed and receive benefits; i.e., the ratio of his benefit wages to his total taxable wages.

The formula is designed to assess variable rates which will raise the equivalent of the total amount paid out as benefits. The percentage relationship between total benefit payments and total benefits wages in the state during three years is determined. This ratio, known as the state experience factor, means that, on the average, the workers who drew benefits received a certain amount of benefits for each dollar of benefit wages paid and the same amount of taxes per dollar of benefit wages is needed to replenish the program. The total amount to be raised is distributed among employers in accordance with their benefit wage ratios; the higher the ratio, the higher the rate. The benefit wage ratio method is used by four states.

Payroll variation method. The payroll variation method is independent of benefit payments to individual workers. Neither benefits nor any benefit derivatives are used to measure unemployment. Experience with unemployment is measured by the decline in an employer's payroll from quarter to quarter or from year to year. The declines are expressed as a percentage of payrolls in the preceding period, so that experience of employers with large and small payrolls may be compared. If the payroll shows no decrease or only a small percentage decrease over a given period, the employer will be eligible for the lowest tax rates. The payroll variation method is used by three states.

Each of the financing methods described has theoretical advantages and disadvantages. Of crucial importance, however, is not so much the selection of one method over another but rather, the manner in which the selected method is structured and implemented. Depending upon the tax schedules used, each of the methods may be found to be inadequate to finance benefit payments, and in these instances, the theoretical justification for the selected method is of very little practical value.

Chapter 5

FINANCIAL ASPECTS OF HAWAII'S PROGRAM

UNEMPLOYMENT COMPENSATION FUND

The Unemployment Compensation Fund (UC Fund) of the State of Hawaii is a special fund established by statute to account for the monies received and paid by the State's unemployment compensation program. The administration of the UC Fund is governed by Chapter 383, Hawaii Revised Statutes, the Hawaii Employment Security Law. The two major classes of transactions recorded in the UC Fund are cash inflows (employer tax payments, investment earnings, and reimbursement payments) and cash outflows (benefit payments and refunds). At a given point in time, the UC Fund consists of the balances of the following accounts.

Clearing account. This is a checking account into which all SUTA taxes are deposited prior to being transferred to the U. S. Treasury. The balance of this account is usually small and currently comprises less than 1% of total UC Fund assets.

Benefit payment account. This is a checking account used for making benefit payments. Monies needed to pay benefits are transferred from the U. S. Treasury to this account. As with the clearing account, its balance is usually small - less than 1% of total assets.

Unemployment Trust Fund account. All monies on deposit at the U. S. Treasury are credited to the State's account in the Federal Unemployment Trust Fund. The balance of this account usually represents the largest asset of the UC Fund and currently comprises over 99% of total assets.

Receivables from reimbursement basis employers. Certain employers (such as the federal government) operate on a reimbursement basis, paying into the program 100% of the benefits paid to former employees. The total amount receivable for benefit payments from these employers at a given time is usually small - less than 1% of total UC Fund assets.

Advances from state and local governments. The state and county governments also pay for 100% of the benefits paid to former employees. These employers, however, are required to make advance payments on a quarterly basis to cover benefit payments. These advance payments represent UC Fund liabilities and currently equal about 1% of total assets.

Other balances receivable and payable. These miscellaneous accounts include amounts due on interstate claims and are usually insignificant to total UC Fund assets.

Fund balance. This is the net of total UC Fund assets and liabilities and is equivalent to the statutorily defined "current reserve fund." The balance of this account represents the total assets available to pay benefits to former employees of employers on a contributory (as opposed to a reimbursement) basis. It is also the most accurate measure of the absolute dollar size of the UC Fund and is the balance most often used in assessing program solvency.

UC FUND BALANCE SHEET

A balance sheet of the UC Fund as of June 30, 1982 is presented in Exhibit 5-1. As noted above, the largest asset is the balance of the State's account in the U. S. Treasury-maintained Unemployment Trust Fund. All other assets and liabilities are relatively insignificant compared to this balance.

FINANCING SYSTEM

The financing system used by Hawaii for its unemployment compensation program is based upon the reserve ratio method. The total tax rate assigned to a given employer is comprised of two components: an experience-rated basic tax rate and a nonexperience-rated fund solvency tax rate.

Basic tax rate. The basic tax rate for each employer is determined at the beginning of the calendar year. Each employer's reserve ratio is computed as of December 31 of the prior year, and based upon this amount, the basic tax rate is determined using the Basic Contribution Rate Schedule, presented in Exhibit 5-2.

Fund solvency tax rate. As of November 30 of each year, the fund solvency tax rate for the coming calendar year is determined. This is based upon the ratio of the UC Fund's fund balance (current reserve fund) to the statutorily defined adequate fund balance (adequate reserve fund). With the computed ratio, the fund solvency tax is determined using the Fund Solvency Contribution Rate Schedule, presented in Exhibit 5-3. For 1982, the fund solvency tax rate was 0.4%, and for 1983, the rate is 0.8%.

Exhibit 5-1

STATE OF HAWAII
UNEMPLOYMENT COMPENSATION FUND

BALANCE SHEET

June 30, 1982

(Unaudited)

Assets

Cash - clearing account	\$ 111,664
Cash - U. S. Treasury (Unemployment Trust Fund account)	101,824,789
Due from federal government	8,603
Due from self-financed employers	<u>54,750</u>
Total assets	\$ <u>101,999,806</u>

Liabilities and Fund Balance

Overdraft - benefit payment account	82,824
Due to state and local government	1,000,606
Due on interstate claims	<u>14,007</u>
Total liabilities	1,097,437
Fund balance	<u>100,902,369</u>
Total liabilities and fund balance	\$ <u>101,999,806</u>

Source: Administrative Services Office, Department of Labor and Industrial Relations.

Exhibit 5-2

BASIC CONTRIBUTION RATE SCHEDULE

	<u>Contribution rate</u>
Reserve ratio:	
.1500 and over	.2 per cent
.1400 - .1499	.4 per cent
.1300 - .1399	.6 per cent
.1200 - .1299	.8 per cent
.1100 - .1199	1.0 per cent
.1000 - .1099	1.2 per cent
.0900 - .0999	1.4 per cent
.0800 - .0899	1.6 per cent
.0700 - .0799	1.8 per cent
.0600 - .0699	2.2 per cent
.0500 - .0599	2.6 per cent
0 - .0499	3.0 per cent
Less than 0	4.5 per cent

Source: Chapter 383-68, Hawaii Revised Statutes.

Exhibit 5-3

FUND SOLVENCY CONTRIBUTION RATE SCHEDULE

<u>Ratio of current reserve fund to adequate reserve fund</u>	<u>Fund solvency contribution rate</u>
2.00 or more	-.5 per cent
1.50 to 1.99	-.2 per cent
1.00 to 1.49	0
.90 to .99	+.4 per cent
.80 to .89	+.8 per cent
.60 to .79	+1.2 per cent
.40 to .59	+1.6 per cent
.20 to .39	+2.0 per cent
Less than .20	+2.4 per cent

Source: Chapter 383-68, Hawaii Revised Statutes.

Total tax rate. The sum of an employer's basic tax rate and the solvency tax rate is his total tax rate subject to the following:

- No employer's rate may be less than zero.
- No employer's rate may be more than 4.5%.
- No employer with a negative reserve ratio may pay less than 4.5%.
- New employers will generally pay at the maximum 4.5% rate until they qualify for experience rating; i. e., been active for one full calendar year.

Taxable wage base. During the coming calendar year, covered employers pay SUTA taxes at the computed total tax rate based upon the wages paid to each employee up to the limit established by the State's taxable wage base. The taxable wage base is calculated each year and is equal to the current average annual wage. For 1982 Hawaii's taxable wage base is \$13,100.

Hawaii is one of fourteen states to utilize what is known as a flexible wage base and is one of only three states to use 100% of the current average annual wage. Because maximum benefit amounts in the State are also based upon current average wages, this helps to ensure that tax receipts will not fall behind benefit payments due to rising wage levels.

CHARGING OF BENEFITS

Along with 28 other states and the District of Columbia, Hawaii charges benefits paid to the accounts of former employers in proportion to the wages paid by each employer during the claimants "base period." The "base period" in Hawaii is the four completed calendar quarters immediately preceding the date when the initial claim for benefits is made. This charging method is based upon the premise that since benefits are determined by base period wages, the allocation objective of experience rating requires that each employer share in benefit costs in proportion to base period wages paid.

Although it is the most popular method used, proportional charging of benefits has a drawback in that it may adversely affect the level of employer involvement in the administration of the program and the determination of benefits. This is because benefit appeal rights are limited to the most recent employer and, thus, may exclude a previous employer who has paid the bulk of the claimant's base period wages. Substantial benefits, then, may be charged against the accounts of employers who have no input into the appeal process, reducing the incentive effect of experience rating.

To counteract this, some states charge benefits to base period employers in inverse chronological order. Benefits are charged to the most recent employer's account until a predetermined maximum is reached, after which the next most recent employers account is charged. This method, however, may result in a less accurate allocation of costs. Depending upon the duration of unemployment, there is the possibility that the accounts of earlier base period

employers may not be charged at all for benefits paid. This method also increases administrative costs, as a constant monitoring of the benefits paid to claimants with two or more base period employers will be required.

Because the effects of each of these charging methods are generally not quantifiable, the selection of one or the other or an entirely different method is largely subjective and will depend ultimately upon the circumstances in each state. However, regardless of the method used, substantially all benefits should be charged to some employer's account. This is necessary to minimize "noncharged benefits" and their detrimental effects upon solvency and experience rating.

Chapter 6

CURRENT DEVELOPMENTS

FEDERAL-STATE SYSTEM

Nationally, the current status of the federal-state system of unemployment compensation is one of financial crisis. Many state programs are deeply in debt to the federal government, and as of June 30, 1982, the federal loan fund had \$7.8 billion in outstanding advances receivable. Examples of the amounts owed then by specific states are presented in Table 6-1. By September 30, 1983, total advances are expected to reach \$13 billion.

Federal Unemployment Account (FUA). The "loan fund" currently has outstanding advances from federal general revenues of \$7.8 billion - the same amount on loan to the states. As the need for additional loans increases, so will the need to increase general revenue advances.

Extended Unemployment Compensation Account (EUCA). This account currently has over \$7 billion in outstanding advances from federal general revenues. This total is largely the result of the extended and supplemental benefits paid during the mid-1970s.

Employment Security Administration Account (ESAA). This account is currently in a break-even position. Very little, if any, surplus monies are available to repay the outstanding general revenue advances of the FUA and EUCA.

Table 6-1

OUTSTANDING ADVANCES FROM THE FEDERAL LOAN FUND

June 30, 1982

	<u>Amount</u> (million)
Illinois	\$ 1,634.1
Pennsylvania	1,608.7
Michigan	1,587.5
Ohio	1,068.2
New Jersey	525.6
Connecticut	272.0
Minnesota	209.8
Wisconsin	181.8
West Virginia	104.8
Kentucky	104.3
Rhode Island	102.0
Others (8 states)	<u>373.0</u>
	<u>\$ 7,771.8</u>

Source: The Bulletin, UBA. Inc., August 9, 1982.

RECENT FEDERAL LEGISLATION

Certain federal legislation was passed in 1981 and 1982, highlights of which are as follows:

Omnibus Budget Reconciliation Act of 1981. This act provided that all federal loan fund advances to the states made after March 31, 1982 be interest-bearing unless repaid within established time limits. The interest rate to be charged is the lower of 10% and the rate paid by the U. S. Treasury on the balances held by the states in the Trust Fund.

This act also provided that the reduction in the SUTA tax credit required by a nonrepayment of advances may be limited if states meet certain financing and solvency requirements.

Tax Equity and Fiscal Responsibility Act of 1982. This act provided that as of January 1, 1983, the FUTA tax rate be raised to a gross tax rate of 3.5% (net of 0.8%), and that the federal taxable wage base be increased from \$6,000 to \$7,000. It also provided that as of January 1, 1985, the FUTA tax rate be raised again to a gross rate of 6.2% (net of 0.8%). To fully qualify for the SUTA tax credit, states must have an experience-rated maximum tax rate of at least 5.4% by this time. This represents a further encouragement of experience rating by the federal government.

In addition, this act established a temporary program of federal supplemental compensation that provides up to 10 weeks of additional benefit payments to claimants who have exhausted their regular benefits. Financed 100% by federal general revenues, the program was allowed to begin after September 11, 1982.

HAWAII'S PROGRAM

Due to the tightening of the qualifications for benefits in 1976, the increase of the taxable wage base from 90% to 100% of the average annual wage in 1977, the implementation of revised tax rate schedules in 1979 and low unemployment rates in recent years, Hawaii's program has recovered well from the \$12 million fund deficit at the end of 1976. Current fund balance is in excess of \$100 million. This amount has raised concerns recently regarding the necessity of maintaining such a seemingly large fund balance.

PART II

FINDINGS AND RECOMMENDATIONS

Chapter 7

FUND BALANCE ADEQUACY

The maintenance of an adequate fund balance is essential to ensure the solvency of the State's unemployment compensation program. An excessively large fund balance, however, represents a misuse of capital and may be politically unacceptable, while a small fund balance may not be adequate to meet the solvency objective. This chapter presents our findings and recommendations regarding the program's current fund balance.

SUMMARY OF FINDING

Our general finding is that the present statutory definition of an adequate fund balance, contribution tax rate schedules, and basic reserve ratio financing method result in a level of fund balance that is adequate to ensure program solvency and is not excessive.

OBJECTIVES OF FUND BALANCE

Maintaining a surplus of monies in excess of immediate current needs (as represented by a positive fund balance) is vital towards preserving the solvency of the State's unemployment compensation program. It is rare that tax receipts exactly equal benefit payments, and in those periods when there is a net outflow of benefit payments, the availability of a positive fund balance

will help ensure the program's continued operation without the need to resort to federal loan fund advances. Further, the availability of a positive fund balance enables the State to smooth out increases in tax rates that are necessary to keep tax receipts in line with increases in benefit payments. Increases in unemployment rates and resultant increases in benefit payments can thus be weathered by the program without sharp increases in tax rates. Finally, the availability of a positive fund balance facilitates the use of a maximum tax rate that effectively limits the tax income that can be generated in a given year. The use of a maximum tax rate is important to avoid placing unnecessarily harsh short-term demands upon cyclical industries that regularly have drastic shifts in employment and benefit costs.

ADEQUATE FUND BALANCE

While the maintenance of program solvency is the overriding reason for the existence of a positive fund balance, there is another consideration. The fund balance should not be so large as to tie up inordinate sums of money that could be used more productively in the local economy. As was noted previously, the bulk of the monies of the UC Fund are held on deposit in the U. S. Treasury. Along with the surplus monies from other states, these sums are invested in obligations of the U. S. government and for all intents and purposes are a source of capital that is not accessible by the local economy. To the furthest extent possible, then, the UC Fund's fund balance should be kept at the minimum level necessary to ensure solvency.

Ascertaining this minimum level of adequacy is a difficult task for which there are very few generally recognized guidelines and standards. The characteristics of each state's financing system, benefit provisions and local economy largely dictate what an adequate fund balance should be and, accordingly, general tests of adequacy may be of only limited value. Thus, although it is widely recognized that the solvency of a state's unemployment compensation program depends to a great extent upon the level of its fund balance, the definition of an adequate fund balance must be tailored to the unique circumstances of each state. No two states are exactly alike and it would not be prudent to assume that what has worked well in one state will also work well in another state.

Even a tailored approach, however, will not be entirely accurate because absolute confirmation of adequacy can only be obtained with a knowledge of the outcome of future events. Because of this, there may be a temptation to compensate by maintaining or striving to achieve a fund balance that is grossly excessive and to disregard all concerns about a minimally adequate amount.

Succumbing to this approach, though, may be a critical error, not only from an economic point of view, but also in a political sense. The maintenance of an excessively large fund balance during a period of high interest rates is disturbing to employers with relatively good unemployment experience, and who would be inclined to view the continued payment of unemployment taxes as an unnecessary drain of capital. An apparently excessive fund balance can also generate concern, justified or not, that it will offer an incentive for unwarranted increases in benefit levels, thereby encouraging idleness and reducing the motivation of the unemployed to seek work.

TREND IN FUND BALANCE

The trend in the UC Fund's fund balance from 1959 to June 30, 1982 is presented in Exhibit 7-1. The following is a recap of this trend and the major factors that have affected the fund balance over this period.

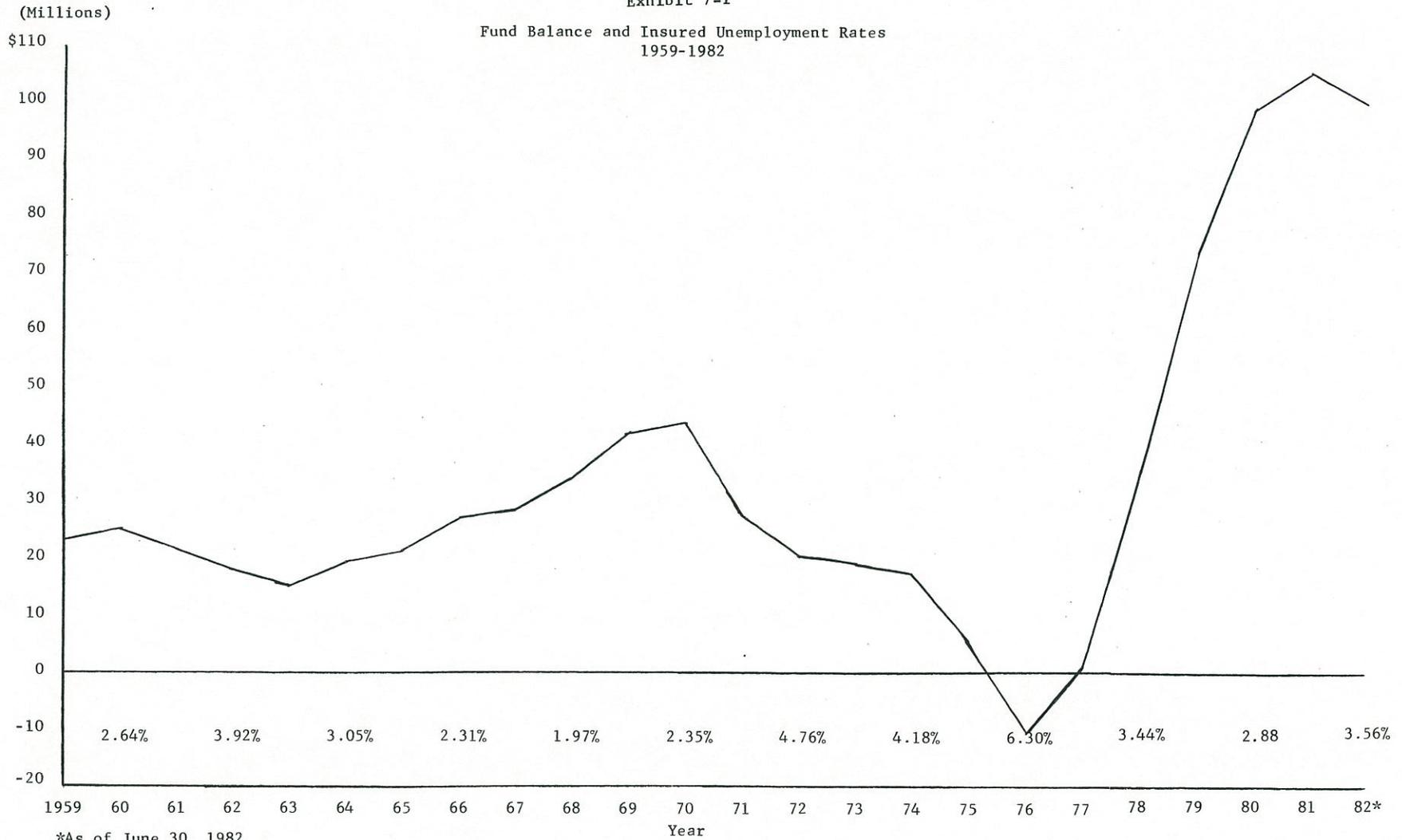
1959 to 1970. During this period, the UC Fund's fund balance grew steadily, reaching a high of about \$44 million at the end of 1970. This was a period of general prosperity in the local economy. Insured unemployment¹ averaged less than 3% and reached a low of 1.62% in 1969, the lowest rate since 1947.

1971 to 1976. The national recessions of 1970 and 1974 dramatically highlighted weaknesses in many state programs and Hawaii's was no exception. During this period, insured unemployment in the State averaged in excess of 4.5%, reaching an all-time, post-war high of 6.3% in 1976. The impact of this increase in insured unemployment was aggravated by the establishment in 1972 by the federal government of a permanent program of up to 13 weeks of extended benefits. The payment of these additional benefits (funded 50% by the federal government and 50% by the states) was triggered by high levels of insured unemployment at the national and state level, and in Hawaii, amounted to over \$15 million from 1971 to 1976.

¹"Insured Unemployment" is a measure of the total covered workers currently receiving unemployment benefits. It differs from and is usually less than total unemployment.

Exhibit 7-1

Fund Balance and Insured Unemployment Rates
1959-1982



*As of June 30, 1982.

Source: Unemployment Insurance Research Section, Department of Labor and Industrial Relations.

The financing system used by the State during this period was unable to meet the demands created by these and other factors. Consequently, the State suspended experience rating as of April 1, 1975 and instituted a flat 3% tax rate on all employers, regardless of experience with unemployment. In addition, effective July 15, 1976 certain changes were made that stiffened the qualification requirements for benefits. Meanwhile, the fund balance steadily declined, and the fund was in a deficit position by almost \$12 million at the end of 1976. The State was forced to borrow from the federal loan fund for the first time, obtaining advances totaling \$22.5 million in order to maintain the liquidity of the UC Fund.

1977 to 1982. Prompted by these developments, the State raised the flat tax rate to 3.5% for 1977 and 1978, raised the taxable wage base from 90% to 100% of the average annual wage in 1977 and effective January 1, 1979, established new tax rate schedules. This, together with the stiffening of requirement qualifications in 1976 and a decline in unemployment, returned the UC Fund to solvency and enabled the State to repay in full its debt to the federal loan fund during 1978. Fund balance increased quickly and by the end of 1981 was in excess of \$106 million. As of June 30, 1982, fund balance amounted to just under \$101 million.

RELATIVE SIZE OF FUND BALANCE

One measure of the size of the UC Fund's fund balance is its dollar amount. Absolute dollar amount, however, is less important to the issue of solvency than the measure of fund balance relative size.

The single most influential element affecting unemployment compensation financing is benefit payments. The need to make benefit payments to claimants is the only reason for a system of financing, and taxes and fund balance must, as a consequence, bear a relationship to benefit payment levels. As benefits increase (as they have since program inception), taxes must also increase and a larger fund balance is needed to maintain program solvency.

The implication of this relationship is that the absolute dollar amount of the UC Fund's fund balance is of less importance to solvency than its size relative to the potential liability for benefit payments. This potential liability is largely influenced by wages, and as wages rise, so do benefit levels. In two-thirds of the states (including Hawaii), maximum benefit amounts are calculated based upon average wages in covered employment.

A well accepted means of gauging the relative size of fund balance is the reserve ratio, which is computed as follows:

$$\text{Reserve ratio} = \frac{\text{Fund balance}}{\text{Total current annual wages}}$$

The reserve ratio does not answer the question as to what constitutes an adequate fund balance, but it does enable a comparison of the UC Fund's current fund balance with those of other states and prior years. It also serves as the basis for the only widely recognized measure of fund balance adequacy, the High Cost Multiple, which is explained in a later section of this study.

STATUTORY ADEQUATE FUND BALANCE

The Hawaii Employment Security Law defines an adequate fund balance (adequate reserve fund) in the following manner:

Adequate fund balance = High benefit cost rate x Total current annual wages

$$\text{Benefit cost rate} = \frac{\text{Total benefits paid}}{\text{Total annual wages}}$$

High benefit cost rate = Highest benefit cost rate of any 12 consecutive month period in the preceding 10 years

Stated another way, the UC Fund's fund balance is considered statutorily adequate when:

$$\text{Reserve ratio} = \text{High benefit cost rate}$$

The assumption contained in this definition is that fund balance should be large enough to cover benefit payments should there be a recurrence of the worst unemployment experience in the past 10 years. This definition is based upon the High Cost Multiple guideline page 44, and is tied to the fund solvency contribution tax in the following manner. As of November 30 of each year, the ratio of the UC Fund's actual fund balance to the statutory adequate fund balance is calculated, the result of which determines the solvency contribution tax rate in effect for the coming calendar year.

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The solvency contribution tax was started in 1979 as part of the tax schedule modifications that became effective in that year. The estimated tax receipts generated by this tax from 1979 to June 30, 1982 are presented in Table 7-1. As the table indicates, the solvency contribution tax has contributed significantly to the buildup in fund balance from 1979.

ANALYSIS OF FUND BALANCE

In order to ascertain whether the UC Fund's current fund balance is indeed in need of adjustment, certain comparisons and tests were performed, the results of which are detailed in the following sections. Before presenting these results, however, some clarification is necessary.

During the course of this study, it became clear that the determination of an "adequate fund balance" is highly subjective and capable of many different interpretations. Quantification of an adequate amount is an exceedingly difficult task and, depending upon the assumptions made, can result in a wide variation of values. Precise dollar figures, therefore, may be very misleading and are subject to constant adjustment as assumptions change.

Because of this, the primary objective of the following analysis was not to derive an optimal fund balance amount, but rather to ascertain whether there exists evidence to support the contention that the current financing system results in a level of fund balance that is clearly excessive or clearly inadequate. Thus, the analysis consists only of comparisons, generally recognized tests of adequacy and forecasts. No attempt was made to compute an

Table 7-1

SOLVENCY CONTRIBUTION TAX RECEIPTS

<u>Year</u>	<u>Solvency contribution tax rate</u>	<u>Tax receipts</u>
1979	1.6 %	\$ 34,729,000
1980	0.8	20,427,000
1981	0.4	10,971,000
Six months ended June 30, 1982	0.4	<u>5,127,000</u>
		\$ <u>71,254,000</u>

Source: Unemployment Insurance Research Section, Department of Labor and Industrial Relations; and Peat, Marwick, Mitchell & Co. estimates.

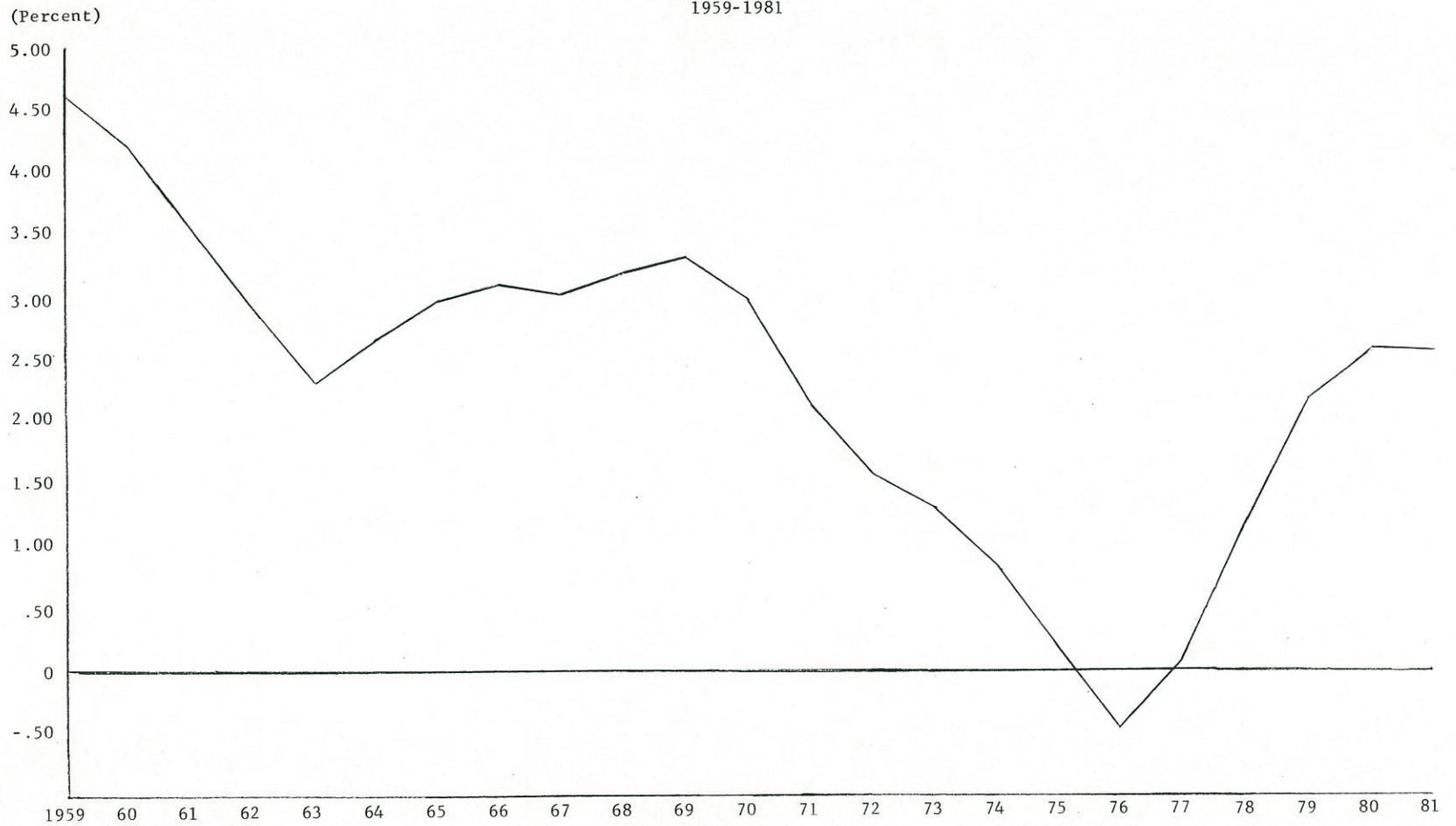
"adequate fund balance"; rather the efforts in this area were directed towards gathering and evaluating available evidence that would support or refute the above contentions. Stated in another manner, then, the objective was to ascertain if a problem actually exists; if so, this would be evidence that the current financing system is producing undesirable results and consequently may be in need of modification and or replacement.

Reserve Ratio Comparisons. To obtain a better understanding of the relative size of the UC Fund's fund balance, its current reserve ratio was compared to those of prior years and other states. The reserve ratio as of December 31 from 1959 to 1981 is presented in Exhibit 7-2. As the exhibit reveals, the highest reserve ratio during this period was recorded at the end of 1959. It is interesting to note that the fund balance at this time was only about \$24 million, or less than one-fourth of the current fund balance. The average reserve ratio over this period was 2.28% and, of the 23 years plotted, 12 had reserve ratios greater than the 2.52% experienced in 1981.

This comparison indicates that although the absolute dollar amount of the current fund balance is historically high, relative to total wages it is only slightly higher than average and is far from being as large as it has been many times in the past.

Table 7-2 presents a ranking of states by reserve ratio as of April 30, 1982. It includes all those states with a positive balance in their U. S. Unemployment Trust Fund accounts and no outstanding federal advances as of that date. As the ranking shows, Hawaii's reserve ratio is among the highest of the states listed, indicating a comparatively high degree of solvency.

Exhibit 7-2
Reserve Ratio
1959-1981



Source: Unemployment Insurance Research Section, Department of Labor and Industrial Relations.

Table 7-2

NONDEBTOR STATES RANKED BY RESERVE RATIO

April 30, 1982

<u>Rank</u>	<u>State</u>	<u>Reserve ratio*</u>
1	Alaska	3.21 %
2	Mississippi	3.09
3	Nevada	2.53
4	New Mexico	2.34
5	Hawaii	2.30
6	Arizona	2.24
7	Florida	2.14
8	Wyoming	2.12
9	California	2.08
10	North Carolina	1.99
11	Kansas	1.88
11	New Hampshire	1.88
12	Oregon	1.86
13	Maryland	1.83
14	Georgia	1.76
15	Idaho	1.50
16	Nebraska	1.29
17	Washington	1.24
18	Oklahoma	1.20
19	Massachusetts	1.07
20	South Carolina	1.03
21	New York	.66
22	Utah	.61
23	Louisiana	.58
24	Montana	.54
25	South Dakota	.43
26	Colorado	.38
27	Alabama	.35
27	North Dakota	.35
28	Tennessee	.28
29	Texas	.24
30	Indiana	.19
31	Iowa	.13
32	Virginia	.09

*U. S. Unemployment Trust Fund account balance as of April 30, 1982 as a percent of estimated total 1981 wages.

Source: The Bulletin, Research Divison, UBA, Inc., August 9, 1982.

This ranking, however, is deceptive because many of the mainland states have recently experienced much higher rates of unemployment than Hawaii, creating greater demands upon their financial resources. While somewhat related to the solvency of the UC Fund, then, Hawaii's current ranking is also due to the precarious financial condition of other state programs, and does not alone indicate whether the current fund balance is or is not at an adequate level.

High Cost Multiple Test. This test of fund balance adequacy was originally devised by the states through the Benefit Financing Committee of the Interstate Conference of Employment Security Agencies (ICESA), in September 1959. It is the only test of fund balance adequacy endorsed by the U. S. Department of Labor. The High Cost Multiple test defines a program's fund balance as adequate when its reserve ratio equals 1.5 to 3.0 times the highest benefit cost rate experienced by the state in a 12-month period since January 1958. Fund balance, thus, is adequate when it is large enough to cover a minimum of 18 months of recession-level benefits.

This test of fund adequacy has been in use for over 20 years. Recently a variation of it was recommended by the National Commission on Unemployment Compensation, which found a substantial correlation between the maintenance of the minimum 1.5 reserve multiple and state program solvency during the period 1973 to 1976.²

²Unemployment Compensation Final Report, July 1980, page 89.

The National Commissions' recommendation for a minimal level of adequacy is a fund balance with a reserve ratio equal to two times the average of the three highest annual benefit cost rates of the prior 15 years. The purpose of using a three-year average high cost rate is to counteract the sudden shifts that the use of single year may cause. The purpose of the limitation to the prior 15 years is to make the measure responsive to changing economic conditions.³

Both of these tests of reserve multiple were performed using the June 30, 1982 UC Fund fund balance, the results of which are presented in Table 7-3. As the results reveal, the current fund balance fails by a wide margin to meet the minimum standards of adequacy of the High Cost Multiple test. This finding, however, is somewhat less serious to the issue of program solvency than these test results would seem to indicate.

As has been mentioned, local conditions largely dictate what the level of an adequate fund balance should be, and general tests of adequacy only serve as a guideline from which departure is frequently warranted. Each state must determine on its own what level of fund balance will be adequate.

In the case of Hawaii, the unemployment financing system has been designed to maintain, at a maximum, a fund balance with a reserve ratio of between 1.0 to 1.5 times the highest benefit cost rate of the preceding 10 years. This was done because at the time that the current tax schedules were being formulated, the Legislature felt that adherence to the 1.5 to 3.0 times guideline would

³Ibid, page 93.

Table 7-3

HIGH COST MULTIPLE TEST OF FUND BALANCE

June 30, 1982

	<u>ICESA version</u>	<u>National Commission recommendation</u>
UC Fund fund balance	\$ 100,902,000	\$ 100,902,000
Total covered wages*	\$ <u>4,227,095,000</u>	\$ <u>4,227,095,000</u>
Reserve ratio	2.39%	2.39%
High benefit cost rate	<u>2.86%**</u>	<u>2.26%***</u>
Reserve multiple	<u>.84</u>	<u>1.06</u>
Recommended reserve multiple	<u>1.5 to 3.0</u>	<u>2.0</u>

*Year ended December 31, 1981.

**12-month period ended September 30, 1976.

***Average of calendar years 1975, 1976, and 1977.

Source: Unemployment Insurance Research Section, Department of Labor and Industrial Relations; Peat, Marwick, Mitchell & Co., calculations.

result in a level of fund balance that would be excessive and unacceptable. Thus, it was intentionally planned that the financing system should produce a fund balance that in most instances would not meet the minimum requirements of the High Cost Multiple test.

Given that past recessions have had a smaller impact upon Hawaii than upon the more industrial areas of the mainland, this decision was, to some extent, valid. Whether or not it was prudent, however, depends upon how responsive the financing system is to increases in benefit payments, and ultimately, how the system fares in future periods of high unemployment.

Test of Revenue-Generating Capacity. In addition to its two times reserve multiple recommendation, the National Commission also recommended that, at a minimum, state financing systems should have a revenue-generating capacity of 30% above the expected long-term benefit cost rate. At a given point in time, in other words, a state's financing system should be capable of producing an average tax rate that is at least 130% of its expected long-term benefit cost rate. Further, the National Commission recommended that if a state chooses not to adhere to the two times reserve multiple rule, then the revenue-generating capacity of its financing system should be adjusted accordingly. Thus, the maintenance of a lower than suggested fund balance should be compensated by a revenue-generating capacity greater than the 130% guideline.⁴

⁴. Ibid, page 93.

Using this recommendation, the revenue-generating capacity of Hawaii's current financing system was tested. As an estimate of the State's long-term benefit cost rate, the average benefit cost rate for the period 1970 to 1981 was used. As an estimate of revenue-generating capacity, the weighted average tax rate (assuming the most unfavorable solvency contribution tax rate) based upon the distribution of taxable wages by employer reserve-ratio for the years 1979, 1980 and 1981 was used. For convenience, taxable wages were used in computing both of these rates. The two rates were compared, the results of which are presented in Table 7-4. As the table reveals, the estimated revenue-generating capacity of the State's financing system is more than 150% of the estimated long-term benefit cost rate.

The revenue-generating capacity of the system, thus, appears to compensate somewhat for the lack of adherence to the High Cost Multiple guideline. Although it is not clear whether this compensation will be sufficient to fully offset the current nonadherence, it does support the position that a lower-than-recommended fund balance can be maintained by the State without jeopardizing program solvency.

Fund Balance Forecasts. As a final test of the adequacy of the State's current fund balance and financing system, forecasts of fund balance and reserve ratio were obtained for the next six calendar years. These forecasts were prepared using a forecasting model developed by the Unemployment Insurance Research Section of the Department of Labor and Industrial Relations (DLIR). Two scenarios were analyzed, one using the DLIR's estimate of future insured unemployment rates, and one using the rates from the period 1973 to 1978 - one of the worst periods of unemployment experience in the history of the program. The results of these forecasts are presented in Table 7-5.

Table 7-4

COMPARISON OF LONG-TERM BENEFIT COST RATE
AND MAXIMUM AVERAGE TAX RATE

<u>Reserve ratio</u>	Percent of total taxable wages*	Maximum total tax rate**	Weighted average tax rate
.1500 and over	26.40%	2.6%	.686%
.1400 - .1499	7.86	2.8	.220
.1300 - .1399	8.75	3.0	.263
.1200 - .1299	7.54	3.2	.241
.1100 - .1199	6.99	3.4	.238
.1000 - .1099	5.70	3.6	.205
.0900 - .0999	5.19	3.8	.197
.8000 - .0899	5.08	4.0	.203
.0700 - .0799	4.22	4.2	.177
.0600 - .0699	2.84	4.5	.128
.0500 - .0599	1.89	4.5	.085
0 - .0499	5.49	4.5	.247
Negative	9.00	4.5	.405
Ineligible	<u>3.05</u>	4.5	<u>.137</u>
	<u>100.00%</u>		
Weighted average maximum tax rate			3.432%
Long-term benefit cost rate***			<u>2.252</u>
Average tax rate as a percent of long-term benefit cost rate			<u>152.40%</u>
Recommended guideline			<u>130%</u>

*Average of 1979, 1980 and 1981.

**Ratio of actual to statutorily adequate fund balance equal to less than .20.
Fund solvency contribution tax rate: 2.4%.

***Total benefits paid, regular and extended as a percent of total taxable wages: 1970 to 1981.

Source: Unemployment Insurance Research Section, Department of Labor and Industrial Relations; Peat, Marwick, Mitchell & Co., computations.

Table 7-5

FUND BALANCE AND RESERVE RATIO FORECASTS

1983 - 1988

<u>Year</u>	<u>DLIR Forecasted IURs*</u>			<u>1973 to 1978 IURs*</u>		
	<u>IUR*</u>	<u>Fund balance</u>	<u>Reserve ratio</u>	<u>IUR*</u>	<u>Fund balance</u>	<u>Reserve ratio</u>
1983	3.50%	\$ 109,900,000	2.33%	3.73%	\$ 104,800,000	2.23%
1984	4.00	106,000,000	2.10	4.18	107,000,000	2.12
1985	4.00	112,200,000	2.08	5.20	83,000,000	1.54
1986	4.00	118,900,000	2.06	6.30	40,900,000	.71
1987	4.00	125,800,000	2.04	4.68	51,500,000	.83
1988	4.00	85,600,000	1.30	3.44	102,000,000	1.54

*Insured unemployment rate.

Source: Unemployment Insurance Research Section, Department of Labor and Industrial Relations; Peat, Marwick, Mitchell & Co., computations.

As the table reveals, a positive fund balance is maintained under both scenarios. In no year does the reserve ratio exceed 2.33%, and in no year does it appear that the program's solvency is placed in jeopardy. The financing system does appear to respond adequately to the increased demands placed upon it by high rates of unemployment and does allow for a sufficient rebuilding of fund balance.

A point that may be raised here is that even in the most critical year of the forecast, fund balance does not drop lower than about \$40 million. Therefore, some downward adjustment could be made in the level of fund balance that would not jeopardize program solvency. The small relative size of the fund balance at that time, however, coupled with the inaccuracy inherent in any type of forecast, suggests that such an adjustment is probably not wise and should not be undertaken.

OVERALL CONCLUSION

As covered previously, the primary objective of the preceding analysis was to ascertain whether there is evidence that the current financing system results in a level of fund balance that is clearly: (1) excessive or (2) clearly inadequate. As the comparison and forecast test results have shown, there is no evidence to indicate that either of these conditions characterize the UC Fund. Consequently, no changes in the current financing system appear to be necessary at this time in order to ensure program solvency or to prevent the maintenance of an excessively large fund balance.

"At this time" is an apt qualification, as only with the passage of time can an accurate assessment be made. As time passes, circumstances and conditions also change, necessitating a reappraisal of assumptions. It is important, therefore, that the type of analysis conducted in this chapter be performed by the State on a regular basis, regardless of the status of the program. Consistent with this, the U. S. Department of Labor has suggested that a thorough review of a state's unemployment compensation financing system be performed at regular three- to five-year intervals. This is sound advice, although given the current uncertain economic outlook, favoring more frequent evaluations would probably be a prudent course of action.

RECOMMENDATIONS

Based upon the preceding, our recommendations are as follows:

1. We recommend that the current statutory definition of an adequate fund balance be retained.
2. We recommend that no modifications be made to the current contribution tax schedules that will result in a material change in fund balance.
3. We recommend that the current reserve ratio financing method be retained.
4. We recommend that the Department of Labor and Industrial Relations conduct evaluations of fund adequacy at regular intervals of not less than three years.

Chapter 8

EXPERIENCE RATING IN PRACTICE

The degree of experience rating in an unemployment compensation program is to a great extent determined by its tax rate structure. Maintaining a close correspondence at the employer level between taxes paid in and benefits paid out maximizes experience rating, and this helps to ensure the long-term integrity of the program by accurately allocating the costs of unemployment.

In this chapter, we present our findings and recommendations regarding experience rating in Hawaii's unemployment compensation program.

SUMMARY OF FINDINGS

In brief, our findings are as follows:

1. There currently exists in Hawaii's program a substantial degree of subsidization of employers with poor unemployment experience by good experience employers.
2. This subsidization is apparently permanent in nature and is caused primarily by a maximum tax rate that is too low to ensure adequate recoupment of costs from negative reserve employers.
3. Thus, the application of experience rating has been limited, resulting in the following detrimental effects:

- An inaccurate allocation of the costs of unemployment;
- Encouragement of the existence of marginal employers and employers and industries that generate relatively high rates of unemployment; and
- A reduction of the incentive for employers to minimize unemployment and stabilize employment.

MEASUREMENT OF EXPERIENCE RATING

Determining the degree of experience rating in the State's program involves ascertaining the relationship at the employer level between: (1) benefits paid to former employees; and (2) taxes. To allow comparisons between firms of differing size, benefits and taxes are usually expressed in relative terms, the most popular common denominator being wages.

Benefit Cost Rate. This is a measure of relative experience with unemployment and is calculated as follows:

$$\text{Benefit cost rate} = \frac{\text{Total benefits paid}}{\text{Total wages}}$$

Taxable wages are sometimes used as the denominator rather than total wages. This, however, may result in a less accurate assessment of relative experience as (1) taxable wages may not completely reflect changes in wage

levels, and (2) taxable wages may not reflect differences in wage levels between industries. Both of these shortcomings apply to Hawaii. In the first case, the taxable wage base for a given year is equivalent to the average wage in the State for the year ended June 30 of the prior year. Thus, changes in taxable wages lag behind changes in wage levels by up to 18 months. In the second case, in high wage industries like construction, taxable wages usually represent a much smaller percentage of total wages than average. The use of taxable wages, accordingly, would tend to overstate the experience of companies in these industries.

Tax rate. This is a measure of the relative allocation of the costs of unemployment and is calculated as follows:

$$\text{Tax rate} = \frac{\text{Total taxes paid}}{\text{Total wages}}$$

Again, taxable wages are sometimes used as the denominator rather than total wages; however, the shortcomings noted above also apply.

Benefit cost multiple. The quotient of the benefit cost rate divided by the tax rate is an overall measure of the degree of experience rating. This benefit cost multiple is calculated as follows:

$$\text{Benefit cost multiple} = \frac{\text{Benefit cost rate}}{\text{Tax rate}}$$

or

$$\text{Benefit cost multiple} = \frac{\text{Total benefits paid}}{\text{Total taxes paid}}$$

A benefit cost multiple of 1 at the individual employer level would mean that benefits paid and taxes paid are equal and would indicate a perfect experience rating. A benefit cost multiple of greater or less than 1 would indicate a deviation from experience rating and some degree of subsidization.¹

DEGREE OF EXPERIENCE RATING

To ascertain the degree of experience rating in Hawaii's program, various comparisons were performed using benefit cost rates, tax rates and benefit cost multiples. The results of these comparisons are presented in the following sections.

81 Comparison between reserve ratio groups. Table 8-1 presents the benefit cost multiples from 1977 to 1981 by reserve ratio groups. As the table indicates, almost without exception, positive reserve ratio employers (i.e., employers with good unemployment experience) over this period have had benefit cost multiples of less than 1. Generally, this would be expected as by definition, positive reserve employers are those whose cumulative tax payments exceed their cumulative benefit payments. Conversely, the employers with negative reserves (i.e., employers with the worst unemployment experience) have consistently had benefit cost multiples greater than 1 over this period.

¹In actual practice, an average benefit cost multiple lesser than 1 is necessary to allow for an adequate buildup of fund balance. For the purposes of this evaluation, however, a benefit cost multiple of 1 is used for convenience.

Table 8-1

BENEFIT COST MULTIPLE BY RESERVE RATIO GROUPS

1977 to 1981

	<u>1977</u>	<u>1978</u>	<u>1979</u>	<u>1980</u>	<u>1981</u>
Reserve Ratio Group:					
.1500 and over	.138	.115	.188	.348	.604
.1400 to .1499	.167	.198	.254	.405	1.209
.1300 to .1399	.235	.209	.308	.336	.268
.1200 to .1299	.287	.283	.187	.420	.493
.1100 to .1199	.312	.332	.404	.342	.692
.1000 to .1099	.371	.217	.291	.448	.504
.0900 to .0999	.343	.292	.210	.391	.503
.0800 to .0899	.482	.429	.368	.416	.443
.0700 to .0799	.581	.437	.377	.557	.652
.0600 to .0699	.665	.536	.503	.766	.692
.0500 to .0599	.816	.618	.613	.844	.903
.0000 to .0499	1.367	.991	.654	1.027	1.396
Negative reserves	2.670	1.941	1.037	1.483	2.181
Ineligible	.630	.436	.321	.384	.596

Source: Unemployment Insurance Research Section, Department of Labor and Industrial Relations; and Peat, Marwick, Mitchell & Co. computations.

This comparison confirms an expectation regarding the operation of the State's financing system. Because of the existence of a maximum tax rate, one would expect that at a given point in time, there would be firms paying more into the system than is necessary based upon their experience, to compensate for the underpayment by firms at the maximum tax rate. In other words, subsidization is expected to occur.

What is revealing, however, is not the confirmation that subsidization exists, but rather the extent of subsidization. From 1977 through 1979, for example, the employers with the very best experience (reserve ratio of .15 and above) paid in taxes an average of more than 6 times the amount paid out in benefits to their former employees. Indeed, during these years, the operation of the State's financing system was almost directly contrary to experience rating. That is, as an employer's experience improved (as reflected in a higher reserve ratio), he paid a proportionately greater amount in taxes (as reflected in a lower benefit cost multiple) - the opposite of what one would expect from an experience-rated system.

The cause of this is that during these years, the State's program was financed largely by flat rate taxes. In 1977 and 1978 all employers paid taxes at a flat rate of 3.5% of taxable wages. In 1979, the first year of the present tax schedules, a solvency contribution tax rate of 1.6% was imposed, and solvency taxes amounted to more than 50% of total taxes paid.

The reductions in the solvency tax rate in 1980 and 1981 lessened somewhat this pattern of overpayment by good experience employers. A substantial degree of subsidization, however, still exists. In 1981, the benefits paid to the former employees of negative reserve employers were more than double the amount of taxes paid by those employers.

Negative reserve employers. Table 8-1 indicates that, currently, the deviation from experience rating in Hawaii's program largely originates from the subsidization of negative reserve employers. As shown in Table 8-2, negative reserve employers represented less than 10% of total employment from 1977 to 1981. On an average, these employers accounted for 15% of the total taxes paid - about 50% more than would be warranted based upon their employment. Benefits paid to their former employees, however, averaged more than 43% of the total benefits paid to claimants during this period. Thus, the payment of a proportionately larger amount in taxes was far exceeded by a substantially greater share of total program costs.

This is also reflected in the taxes and benefits paid from 1977 to 1981. As shown in Table 8-3, in each year benefits exceeded taxes for a net benefits paid total of about \$37.5 million for the period.

As was noted, the existence of a group of subsidized employers is expected in a program that utilizes a maximum tax rate. Maximum tax rates serve an important function in that they ease the burden of the unemployment tax upon cyclical industries. All of the states have maximum tax rates and like Hawaii, have, at a given point in time, subsidized employers.

In order to achieve the primary objective of experience rating (the accurate allocation of costs), however, this subsidization should not continue indefinitely. During a downturn in the economy, employers in cyclical industries may be allowed to pay less than a proportionate share of program costs only if this underpayment is offset later by the payment of an equally larger share of costs. In this manner, the cost allocation objective of experience rating can be achieved in the long-term without imposing severe short-term demands.

Table 8-2

NEGATIVE RESERVE EMPLOYERS - EMPLOYMENT, BENEFIT
AND TAX PERCENTAGES

1977 to 1981*

<u>Calendar Year</u>	Employment - as a percent of total covered <u>employment</u>	Taxes - as a percent of <u>total taxes</u>	Benefits - as a percent of total <u>benefits</u>
1977	9%	11%	48%
1978	9	10	46
1979	8	15	37
1980	7	19	41
1981	7	22	47

*Active employers only.

Source: Unemployment Insurance Research Section, Department of Labor and Industrial Relations.

Table 8-3

TAXES AND BENEFITS PAID - NEGATIVE
RESERVE EMPLOYERS

1977 to 1981

	<u>1977</u>	<u>1978</u>	<u>1979</u>	<u>1980</u>	<u>1981</u>	<u>Total</u>
Taxes paid	\$ 7,296,000	7,710,000	9,696,000	10,005,000	10,948,000	45,655,000
Benefits paid	<u>19,480,000</u>	<u>14,960,000</u>	<u>10,049,000</u>	<u>14,836,000</u>	<u>23,878,000</u>	<u>83,203,000</u>
Net taxes (benefits) paid	\$ <u>(12,184,000)</u>	<u>(7,250,000)</u>	<u>(353,000)</u>	<u>(4,831,000)</u>	<u>(12,930,000)</u>	<u>(37,548,000)</u>

Source: Unemployment Insurance Research Section, Department of Labor and Industrial Relations.

Comparison by industry. The extent and consistency of the underpayment of taxes by negative reserve employers suggest that the subsidization existing in Hawaii's program is not limited merely to downturns in the economy. To ascertain further its extent and nature, comparisons of benefit cost multiples by industry were performed. The results of these comparisons are presented in Table 8-4.

As revealed in the table, from 1964 to 1981, each of the seven industry groups noted was subsidized during at least one year in the period. A consistent pattern of subsidization, however, has occurred only in the agriculture and construction industries. In the agriculture industry, in each of the 18 years during the period, taxes paid were exceeded by benefit payments. In the construction industry, benefits exceeded taxes in all but 4 years and have done so in every year since 1970, with the exception of 1979.

The extent of this subsidization of the agriculture and construction industries is revealed further in a comparison of the taxes and benefits paid by industry presented in Table 8-5. From 1964 to 1981, total benefits exceeded taxes paid by employers in these two industries by over \$60 million. As also revealed in the table, the primary subsidizing industries have been wholesale and retail trade, and services.

A question that may be raised here is "To what extent has this pattern of subsidization been altered by the revised tax schedules adopted in 1979?" To ascertain the answer to this, a calculation of the total taxes less benefits

Table 8-4

BENEFIT COST MULTIPLES BY INDUSTRY

1964 to 1981

<u>Industry</u>	<u>Average benefit cost multiple</u>	<u>Years when benefit cost multiple greater than 1</u>	
		<u>Number</u>	<u>% of total years</u>
Agriculture	1.474	18	100 %
Construction*	1.644	14	78
Manufacturing	.896	10	56
Transportation, communications and utilities	.632	3	17
Wholesale and retail trade	.565	2	11
Finance, insurance and real estate	.764	9	50
Services**	.599	1	6

*Includes mining

**Includes other

Source: Unemployment Insurance Research Section, Department of Labor and Industrial Relations; and Peat, Marwick, Mitchell & Co. computations.

Table 8-5

TOTAL BENEFITS AND TAXES PAID BY INDUSTRY

1964 to 1981

	<u>Agriculture</u>	<u>Construc- tion*</u>	<u>Manufactu- ring</u>	<u>Transporta- tion, commu- nication and utilities</u>	<u>Wholesale and retail trade</u>	<u>Finance, insurance and real estate</u>	<u>Services**</u>
Total taxes	\$ 8,087,000	88,450,000	57,051,000	63,347,000	147,715,000	70,746,000	133,088,000
Less total benefits	<u>11,919,000</u>	<u>145,379,000</u>	<u>51,105,000</u>	<u>40,064,000</u>	<u>83,482,000</u>	<u>54,058,000</u>	<u>79,702,000</u>
Net taxes (benefits)	\$ <u>(3,832,000)</u>	<u>(56,929,000)</u>	<u>5,946,000</u>	<u>23,283,000</u>	<u>64,233,000</u>	<u>16,688,000</u>	<u>53,386,000</u>

*Includes mining

**Includes other

Source: Unemployment Insurance Research Section, Department of Labor and Industrial Relations.

paid by industry was performed for the years 1979 to 1981. The results of this calculation were compared to the period 1964 to 1978 and are presented in Table 8-6. As the table shows, the subsidization of the agriculture and construction industries appears to have lessened somewhat from 1979. It is still substantial, however, and the net benefits paid by these industries of \$10 million in 1981 was the second highest in the 18 years of the comparison.

The cause of the subsidization. As was alluded to, the cause of the current level of subsidization is the present tax structure. Primarily, the cause is the existence of a maximum tax rate that is too low to ensure the adequate recoupment, in the long-term, of the program costs generated by negative reserve employers. That the evidently low maximum tax rate is the main contributor to the current subsidization is indicated by the analysis of benefit cost multiples presented in Table 8-1 and the discussion of negative reserve employers. Additional confirmation of this is provided by a comparison of the long-term benefit cost rate of negative reserve employers and the current maximum tax rate of 4.5%.

To properly allocate the costs of unemployment, in the long-term, the taxes paid by negative reserve employers must, at a minimum, be equal to the benefits paid to their former employees. That is, the long-term average benefit cost rate must equal the long-term average tax rate. As is revealed in Table 8-7, the average benefit cost rate for negative reserve employers for the 10-year period from 1972 to 1981 was about 7.8%. This average benefit cost rate exceeds the current maximum tax rate by more than two-thirds. With the exception of 1972, in every year the benefit cost rate has exceeded 4.5%, and in 3 of the years, it was more than double the current maximum tax rate.

Table 8-6

TAXES PAID LESS BENEFITS PAID BY INDUSTRY

1979 to 1981

(\$ Thousands)

<u>Industry</u>	<u>Net taxes (benefits) paid</u>					
	<u>1979</u>	<u>1980</u>	<u>1981</u>	<u>Total</u>	<u>Yearly average 1979 to 1981</u>	<u>Yearly average 1964 to 1978</u>
Agriculture	\$ (20)	(124)	(85)	(229)	(76)	(240)
Construction*	3,668	(2,138)	(10,044)	(8,514)	(2,838)	(3,228)
Manufacturing	3,408	852	(223)	4,037	1,346	127
Transportation, communications and utilities	4,082	2,416	9	6,507	2,169	1,118
Wholesale and retail trade	11,628	6,729	3,819	22,176	7,392	2,804
Finance, insurance and real estate	5,441	3,556	1,956	10,953	3,651	382
Services**	9,561	5,887	3,329	18,777	6,259	2,307

*Includes mining

**Includes other

Source: Unemployment Insurance Research Section, Department of Labor and Industrial Relations; and Peat, Marwick, Mitchell & Co. computations.

Reducing the subsidization. Reducing the level of subsidization, then, is largely a matter of reducing the current discrepancy between the long-term benefit cost rate of negative reserve employers and the maximum tax rate. Theoretically, this could be done by reducing benefits, increasing taxes or both. Given that the restriction of benefits to former employees of negative reserve employers is unacceptable, increasing taxes by raising the maximum tax rate remains as the only viable alternative.

Selection of the appropriate maximum tax rate should give consideration to the long-term benefit cost rate of negative reserve employers. Based upon the data presented in Table 8-7, it appears that a rate between 7% to 8% would be adequate to eliminate the bulk of the current subsidization.

Using the middle rate of 7.5%, the effects upon the distribution of taxes between negative and positive reserve employers and on fund balance from 1979 to 1981 were calculated and are presented in Table 8-8. As the table reveals, if the maximum tax rate had been 7.5% during this period, an annual average of about \$7 million in additional taxes would have been paid into the UC Fund by negative reserve employers. These additional taxes would have reduced the solvency tax rate by 0.4% in 1980 and 1981, resulting in an average tax reduction to positive reserve employers of about \$10 million in those years. The net of the additional taxes and tax reductions would have been an increase in fund balance of about \$2 million - just under 2% of the current actual fund balance.

Total tax revenues, then, would have been largely unaffected, and the primary result of raising the maximum tax rate would have been a shifting of a portion of the tax burden from positive reserve employers to negative reserve employers.

Table 8-7

AVERAGE COST RATE - NEGATIVE RESERVE EMPLOYERS

1972 to 1981

	Benefits (000)	Taxable wages (000)	Average benefit cost rate
1981	\$ 24,774	269,151	9.204%
1980	15,508	240,076	6.460
1979	10,657	230,486	4.624
1978	15,605	232,451	6.713
1977	20,143	221,054	9.112
1976	24,078	185,423	12.985
1975	14,166	158,257	8.951
1974	9,030	109,897	8.217
1973	6,477	100,275	6.459
1972	<u>4,211</u>	<u>101,949</u>	<u>4.130</u>
Total	\$ <u>144,649</u>	<u>1,849,019</u>	<u>7.823%</u>

Source: Unemployment Insurance Research Section, Department of Labor and Industrial Relations; and Peat, Marwick, Mitchell & Co. computations.

Table 8-8

EFFECT OF AN INCREASE IN MAXIMUM TAX RATE TO 7.5%

1979 to 1981

	<u>1979</u>	<u>1980</u>	<u>1981</u>	<u>Totals</u>
Reduction in solvency contribution tax rate	<u>-</u>	<u>0.4 %</u>	<u>0.4 %</u>	<u>-</u>
Additional taxes generated by negative reserve employers	\$ 6,664,000	6,995,000	7,869,000	21,528,000
Tax reductions:				
From reduction in solvency tax rate	<u>-</u>	<u>9,418,000</u>	<u>10,216,000</u>	<u>19,634,000</u>
Net increase (decrease) in fund balance	\$ <u>6,664,000</u>	<u>(2,423,000)</u>	<u>(2,347,000)</u>	<u>1,894,000</u>

Source: Unemployment Insurance Research Section, Department of Labor and Industrial Relations; Peat, Marwick, Mitchell & Co., estimates.

Concluding observations. The preceding analysis was not performed with the intention of implicating any one industry or industries. Within each industry, there are employers with good experience and employers with bad experience with unemployment. Rather, the objectives were: (1) to determine the existence of subsidization in Hawaii's unemployment compensation program, and (2) to determine the extent and duration of any noted subsidization. These objectives were derived from the overall goal of ascertaining the degree of experience rating in Hawaii's program.

The comparisons of reserve ratio groups and the data presented on negative reserve employers revealed that a significant degree of subsidization exists in the program. Whether it is permanent at the level of the individual employer could only have been determined conclusively by tracing the history of a prohibitively large sample of employers. The additional comparisons and data by industry, however, do lend strong support to this contention.

The existence of this substantial and apparently permanent subsidization represents a significant departure from experience rating, which has the detrimental effects of:

- Contributing towards an inaccurate allocation of the costs of unemployment;
- Encouraging the existence of marginal employers, and employers and industries that generate relatively high levels of unemployment; and
- Reducing the incentive for employers to stabilize employment.

The course of action that one may decide upon at this juncture is dependent upon many considerations including:

- The degree of acceptance of the merits of experience rating;
- The estimation of the impact of the detrimental affects noted above;
- The estimation of the impact upon subsidized employers of a more complete implementation of experience rating; and
- The political acceptability of available alternatives.

In the background section of this study, the argument was presented that experience rating enjoys a position of "presumptive favor," and that unless specific and convincing evidence exists to the contrary, its effects must be assumed to be beneficial and preferred. Ascertaining the existence of such evidence is beyond the scope of this study; however, it may suffice to say that there is no generally applicable justification for a less than complete implementation of experience rating. Consequently, each move towards subsidization must be examined on an individual basis, giving consideration to its specific facts and circumstances.

This guideline applies as well to the condition existing in Hawaii's program. Unless specific and convincing evidence is available to justify the present level of subsidization, steps should be taken to reduce it and to carry out a more complete application of experience rating.

OTHER MATTERS REQUIRING CONSIDERATION

Implementation. A tax rate of 7.5% is two-thirds greater than the current maximum rate, and such an increase might be viewed as an unnecessarily harsh burden to impose upon employers. The perceived severity of the added burden, however, is lessened by several factors. First, because the 7.5% tax rate is based upon an average benefit cost rate, it will still not be high enough to allocate the costs generated by employers who regularly incur much higher than average levels of unemployment. Especially so in the cyclical industries like agriculture and construction, there are instances of employers with benefit cost rates in excess of 50% and at this level, only a dramatic increase in employment would enable more than a minimal recoupment of costs.

Second, the unemployment tax is applied to taxable wages, which on the average, equal about 70% of total wages. In a high wage industry like construction, this percentage is even smaller - about 62%. In terms of total wages, therefore, the 7.5% maximum rate is a correspondingly smaller percentage, in the range of about 4.6% to 5.3%.

Third, if it is determined that a 7.5% maximum tax rate would be too harsh, its severity can be eased by phasing in the necessary increase, say, in annual one-percentage point increments. In this way, employers will have an opportunity to make whatever adjustments are available without having to deal immediately with the full impact of the maximum tax rate. Similarly, the maximum tax rate increase for any employer could be limited to no more than 1% in a single year. This approach is used in Wisconsin and is designed to prevent a drastic increase in tax rates resulting from the sudden onset of unusually high levels of unemployment.

New employers. Under present statutes, new employers now pay unemployment taxes at the maximum rate until they have been in business for one full calendar year. At that time, they qualify for experience rating and often a reduced rate. Whether any change in this treatment of new employers is warranted was not ascertainable, primarily because of a lack of data regarding the effects upon benefits and taxes of a key variable: the rate of new business failures. Each business that fails generates a much larger potential demand upon program resources, and indications are that the failure rate among new businesses is substantially higher than average.

Because of the lack of data, no analysis can be presented regarding the treatment of new employers. There was no conclusive evidence that new employers as a group should or should not be paying taxes at the current maximum rate, nor was there any conclusive evidence that increases in the maximum tax rate should or should not apply to new employers.

Federal developments. As was covered more fully in another section of this study, recent federal law changes will require all states to raise their maximum experience-rated tax rate to a minimum of 5.4% beginning in 1985. This is explicit encouragement of more experience rating and reduced subsidization at the state level by the federal government. Regardless of the outcome of any discussions pertaining to the existing degree of subsidization in Hawaii's program, then, the maximum basic contribution tax rate should be increased to at least 5.4%, effective January 1, 1985.

RECOMMENDATIONS

Based upon the preceding, our recommendations are that:

1. The Legislature consider increasing by increment, the maximum basic contribution tax rate to approximately 7.5%.
3. Regardless of the outcome of recommendation 1, the maximum basic contribution tax rate be increased to a minimum of 5.4%, effective January 1, 1985, to comply with federal requirements.

Chapter 9

EMPLOYER RESERVES

The maintenance of individual employer accounts and reserves is an integral part of the reserve ratio financing method. Ideally, there should be a close correspondence between the total of employer reserves and fund balance, minimizing the incidence of "fictitious reserves" and their related effects. In actual practice, an exact equality is rarely achieved, and depending upon the size of the discrepancy, this may result in a reduction in experience rating and artificially low contribution tax rates, thereby jeopardizing program solvency.

This chapter presents our findings and recommendations on the State's current practices regarding the maintenance of employer accounts and reserves.

SUMMARY OF FINDINGS

In brief, our findings are as follows:

1. Currently the total of employer reserve balances exceeds actual program fund balance by more than \$120 million. This substantial balance of "fictitious reserves" is the result primarily of past benefit charging practices and is largely a carryover from the years 1976 and prior.

2. Because the growth in fictitious reserves has been curtailed in recent years, their associated detrimental effects upon experience rating and solvency have been largely mitigated by the contribution tax rate schedules established in 1979.

3. The potential for a renewed buildup in fictitious reserves, however, is still present and will continue to exist unless a change is made in current benefit charging practices and certain guidelines are adhered to in the future.

FUND BALANCE AND EMPLOYER RESERVES

In Hawaii, as with other states using the reserve ratio financing method, an account is maintained for each participating employer that is credited for all taxes paid in and generally all benefits paid out since the inception of the program. The balance of this account is known as the employer's reserve and it may be a positive or negative amount, depending upon the employer's experience with the program. In most cases, a higher reserve balance results in a lower basic and total contribution tax rate, with negative reserve employers paying the maximum allowable rate.

In a system with pure experience rating and in which the only transactions are tax payments and benefit payments, the sum of all employer reserves must equal program fund balance. All taxes paid in and benefits paid out should increase and decrease employer reserves and fund balance by a like amount. Consequently, any inequality can only be the result of erroneous entries in one, the other or both.

In actual practice, equality is usually not maintained because of the existence of transactions that affect either employer reserves or fund balance, but not both. These transactions are as follows:

Noncredited income. Investment income earned on surplus monies and interest and penalties assessed against employers are generally not credited to employer accounts, but do result in increases in cash and fund balance. These items increase the level of fund balance relative to employer reserves.

Noncharged benefits. In order to ease employer resistance to the expansion of benefit provisions and to emphasize the employment stabilization objective of experience rating, certain benefits paid to claimants are not charged to employer accounts, ostensibly eliminating their impact upon the calculation of tax rates. These noncharged benefits, however, do result in a decrease in cash and, accordingly, decrease the level of fund balance relative to employer reserves.

Lapsing of inactive accounts. After a defined period, the accounts of inactive employers are purged, removing any remaining reserve balances. In Hawaii, accounts are purged after five consecutive calendar years of inactivity. If the remaining reserves in the accounts to be purged are positive, purging will decrease total employer reserves. If negative, total employer reserves will increase. In either case, no cash will be received or paid out and the amount of fund balance will not be affected.

FICTITIOUS EMPLOYER RESERVES

Exhibit 9-1 presents the total of employer reserves and fund balance in Hawaii's program from 1970 to 1981. During this period, employer reserves were consistently greater than fund balance and at December 31, 1981, exceeded fund balance by over \$120 million. This excess of employer reserves is called "fictitious reserves" or "paper reserves" - reserves that exist on paper only and that are not backed by cash or other assets.

The formation of fictitious reserves is closely correlated to the pattern of noncharged benefits. This is shown in Exhibit 9-2. As the exhibit indicates, the buildup in fictitious reserves occurred mainly in the years 1976 and prior. In 1976 the state instituted certain changes in the qualification requirements for benefits that effectively eliminated a substantial source of noncharged benefits and curtailed the growth of fictitious reserves. The current balance, thus, is largely a carryover from the mid-1970s, and as shown in Table 9-1, has declined somewhat in recent years although it is still a substantial amount.

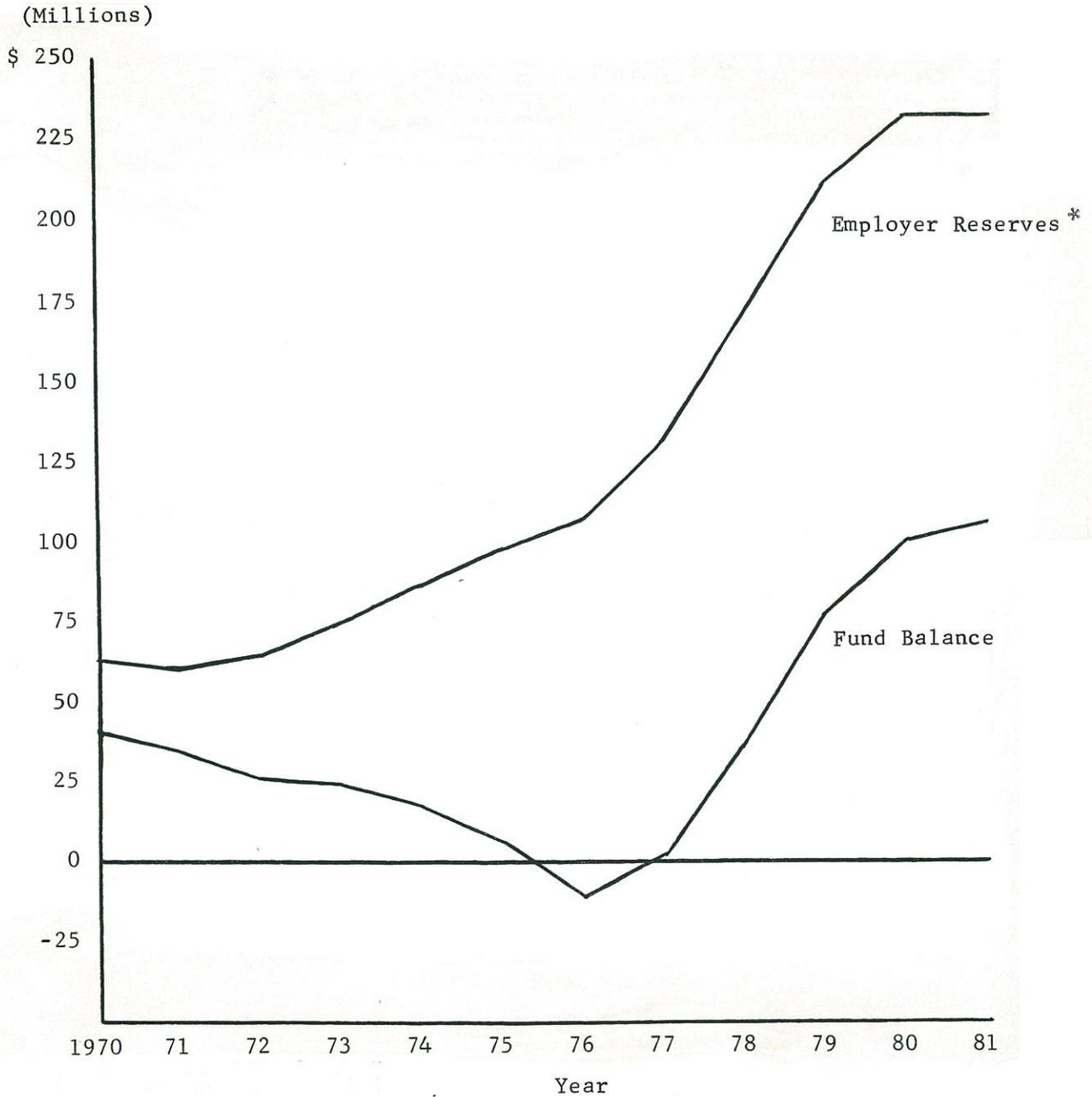
ARTIFICIALLY LOW TAX RATES

One of the potential problems of a large amount of fictitious reserves is the premature triggering of lower tax rates. This occurs because tax rates are computed based upon employer reserve balances that are much higher than actual fund balances. This jeopardizes program solvency as tax receipts are reduced without corresponding reductions in benefit payment levels.

Exhibit 9-1

Employer Reserves and Fund Balance

1970 - 1981



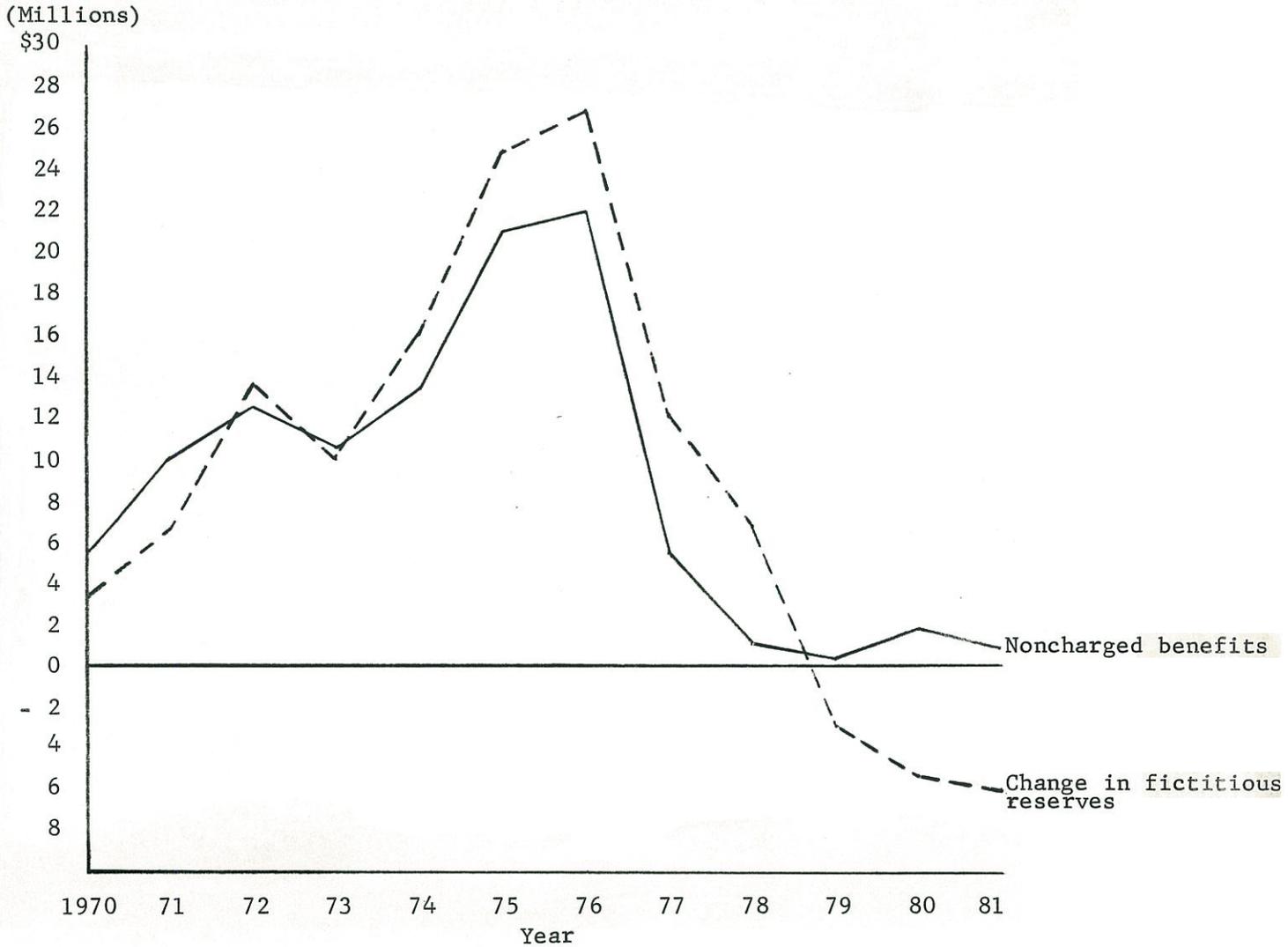
*Active accounts only.

Source: Unemployment Insurance Research Section, Department of Labor and Industrial Relations.

Exhibit 9-2

Noncharged Benefits and Change in Fictitious Reserves

1970 - 1981



Source: Unemployment Insurance Research Section, Department of Labor and Industrial Relations.

Table 9-1
Fictitious Reserves*
1970 to 1981

	<u>As of December 31</u>
1970	\$ 19,762,000
1971	26,372,000
1972	40,195,000
1973	50,214,000
1974	66,325,000
1975	91,141,000
1976	118,056,000
1977	130,075,000
1978	136,732,000
1979	134,067,000
1980	128,790,000
1981	122,769,000

*Active accounts only.

Source: Unemployment Insurance Research Section, Department of Labor and Industrial Relations.

In Hawaii this potential problem is mitigated by the curtailment in the buildup of fictitious reserves after 1976, and the establishment in 1979 of a separate solvency contribution tax. As was covered previously, this tax (which is determined solely by the solvency of the UC Fund and is not affected by the balance of employer reserves) has made a significant contribution towards the maintenance of a positive fund balance since 1979.

The use of the solvency contribution tax to generate the tax receipts necessary to maintain an adequate fund balance, however, has the effect of reducing the level of experience rating in the State's financing system. Because it is a flat rate tax, it results in employers with very good experience paying taxes in amounts that far exceed their benefit payments. To maximize experience rating, then, its use should be minimized. To the extent that employer reserve balances and reserve ratios are artificially high and contribute towards the calculation of basic (experience rated) contribution tax rates that are too low to generate sufficient revenues, the use of the solvency contribution tax will be prolonged, lessening the role of experience in the State's financing system.

During periods of high unemployment or in a period of recovery, the use of the solvency contribution tax to maintain liquidity can be justified. Its continued use over extended periods, however, would be an indication that the basic tax rate schedule is inadequate to generate the revenues necessitated by long-term benefit payment patterns.

Any suggested inadequacy in the basic contribution tax rate schedule can arise from two general deficiencies. These are:

- Basic tax rates that are too low for positive reserve employers; and
- Basic tax rates that are too low for negative reserve employers.

The primary concern here is the possible detrimental effect of the current substantial balance of fictitious reserves - by definition, excess positive reserve balances. The emphasis of the remainder of this section, accordingly, will be on ascertaining the existence of the first deficiency: basic tax rates that are too low for positive reserve employers. The matters relating to negative reserve employers are addressed in the preceding chapter of this study.

If the basic tax is to operate properly, in the long-term, basic tax receipts from positive reserve employers should at least approximately equal or preferably be slightly greater than benefit payments. If basic tax receipts are less than benefit payments, fund balance will be reduced, resulting in a continued use of the solvency tax. In this case, basic tax receipts must be increased, and this could be accomplished by (1) reducing employer reserves and reserve ratios (eliminating fictitious reserves), or by (2) raising basic tax rates.

To determine whether the basic contribution tax is generating sufficient revenues to cover benefit costs for positive reserve employers, basic tax receipts and total benefits for all positive reserve employers were compared. As shown in Table 9-2, for years 1979 to 1981, basic tax receipts were substantially equivalent to benefit payments. Although the data is limited

Table 9-2

Basic Tax Receipts and Total Benefit Payments -
Positive Reserve Employers*

1979 to 1981

<u>Year</u>	<u>Total tax receipts</u>	<u>Solvency tax receipts</u>	<u>Basic tax receipts</u>	<u>Total benefits</u>	<u>Difference</u>
1979	\$ 52,223,000	34,729,000	17,494,000	16,299,000	1,195,000
1980	40,470,000	20,427,000	20,043,000	20,362,000	(319,000)
1981	<u>36,110,000</u>	<u>10,971,000</u>	<u>25,139,000</u>	<u>25,535,000</u>	<u>(396,000)</u>
Totals	\$ <u>128,803,000</u>	<u>66,127,000</u>	<u>62,676,000</u>	<u>62,196,000</u>	<u>480,000</u>

*Active accounts only.

Source: Unemployment Insurance Research Section, Department of Labor and Industrial Relations; Peat, Marwick, Mitchell & Co. estimates.

because of the recent implementation of the current tax schedules, the presence of fictitious reserves does not appear to have detrimentally affected the revenue-generating capacity of the basic contribution tax.

This finding is not entirely unexpected as during the preparation of the current contribution tax schedules in 1977, the DLIR utilized a distribution of employers by reserve ratio that was based upon total employer reserves. The impact of fictitious reserves, thus, was considered in the development of the basic tax schedule, and this consideration has not been invalidated since then because the balance of fictitious reserves has not undergone a substantial change. From the perspective of experience rating, the basic tax and large fictitious reserves for positive reserve employers do not currently appear to require significant modification. Minor alterations may be warranted, but this would depend largely upon the impact of the basic tax upon individual employers, the focus upon which is beyond the scope of this study.

MINIMIZING THE FUTURE IMPACT OF FICTITIOUS RESERVES

As the preceding has shown, the current large balance of fictitious reserves does not appear to have had a significant impact upon the experience rating, financing and solvency of the State's unemployment compensation program. To ensure that this will also be so in the future, certain steps should be taken that are directed towards minimizing the potentially detrimental impact of fictitious reserves.

Minimizing the future impact of fictitious reserves is largely a matter of minimizing their growth. This growth to a great extent is determined by the level of noncharged benefits. As noncharged benefits increase or decrease, so do fictitious reserves.

As was noted, in 1976 certain changes were made that substantially reduced the level of noncharged benefits and curtailed the growth in fictitious reserves. As shown in Table 9-3, noncharges as a percent of total benefits paid dropped drastically thereafter. The potential, however, for a significant increase in noncharged benefits and a corresponding increase in fictitious reserves is still present in the current noncharging of extended benefits. As the table reveals, from 1970 to 1981 these benefits amounted to over \$22 million - more than one-sixth of the current balance of fictitious reserves. To ensure against a renewed buildup of fictitious reserves, extended benefits should be classified as chargeable benefits.

The argument for the noncharging of extended benefits is the same argument that is used to justify noncharged benefits in general. Extended benefits, it is said, represent the cost of unemployment that is beyond the control of individual employers. The long-term unemployment that results in the payment of extended benefits is caused by general economic variables and as such, its cost should be borne by all employers collectively. To do otherwise would hold employers liable for the payment of costs which are not their responsibility, reducing the effectiveness of the employment stabilization objective of experience rating.

Table 9-3

Total and Noncharged Benefits

1970 to 1981

	<u>Total</u> <u>benefits</u>	<u>Total</u> <u>noncharged</u> <u>benefits</u>	<u>%</u>	<u>Extended</u> <u>benefits</u>	<u>%</u>	<u>Other</u> <u>noncharged</u> <u>benefits</u>	<u>%</u>
1970	\$ 14,678,000	5,883,000	40.1%	\$ -	-%	\$ 5,883,000	40.1%
1971	28,267,000	10,042,000	35.5	297,000	1.1	9,745,000	34.4
1972	30,892,000	12,428,000	40.2	2,665,000	8.6	9,763,000	31.6
1973	26,685,000	10,652,000	39.9	5,000	-	10,647,000	39.9
1974	35,307,000	13,659,000	38.7	(3,000)	-	13,662,000	38.7
1975	51,980,000	21,162,000	40.7	4,356,000	8.4	16,806,000	32.3
1976	66,060,000	22,067,000	33.4	7,717,000	11.7	14,350,000	21.7
1977	50,183,000	5,785,000	11.5	4,895,000	9.8	890,000	1.7
1978	38,309,000	1,169,000	3.1	736,000	1.9	433,000	1.2
1979	31,366,000	267,000	.9	(6,000)	-	273,000	.9
1980	42,620,000	1,952,000	4.6	1,468,000	3.4	484,000	1.2
1981	57,540,000	986,000	1.7	367,000	.6	619,000	1.1
	\$ <u>473,887,000</u>	<u>106,052,000</u>	<u>22.4%</u>	\$ <u>22,497,000</u>	<u>4.7%</u>	\$ <u>83,555,000</u>	<u>17.7%</u>

Source: Unemployment Insurance Research Section, Department of Labor and Industrial Relations.

This argument is seemingly convincing; however, it lacks validity because it disregards the primary objective of experience rating: the proper allocation of costs. As is detailed elsewhere in this study, this objective requires that once a determination to pay benefits is made, the cost of these benefits must be borne by those enterprises generating the related unemployment. This should be done regardless of the controllable or uncontrollable nature of the underlying unemployment, unless there is specific evidence that doing so would have undesirable results.

Such evidence is not available to support the noncharging of extended benefits, and accordingly, these benefits should be classified as chargeable for the purposes of experience rating.

Referring again to Table 9-3, other noncharged benefits are currently about 1% of total benefits. In addition to extended benefits, the Employment Security Law allows for the noncharging of benefits under the following circumstances (per "A Handbook for Employers," Department of Labor and Industrial Relations, March 1982):

- Claimant worked part-time in the base period and continues to work to the same extent for the subject base period employer while receiving benefits.
- Claimant is enrolled in a vocational or retraining course approved by the Director of the Department of Labor and Industrial Relations.
- Claimant qualifies only by combining wages earned in two or more states.

- Benefits are overpaid due to ineligibility or disqualification unless employer was at fault in failing to provide information required by law.

The above categories currently do not appear to contain the potential for a significant increase in noncharged benefits. If in the future, however, the noncharged benefits arising from these categories do become material, serious consideration should be given to their reclassification as chargeable benefits.

As the current recession deepens, the motivation will become stronger to broaden unemployment benefit provisions. This has already occurred at the federal level. The manner in which this can be accomplished with the least amount of employer resistance would be to classify such additional benefits as nonchargeable. To the extent that this results in renewed buildup in fictitious reserves, the attainment of the primary objective of experience rating would be hindered as the costs of these additional benefits would be absorbed by all employers, regardless of their unemployment experience, through the operation of the solvency contribution tax.

Because of this, the costs arising from any future expansion of benefit provisions should be classified as chargeable, unless there is specific and convincing evidence that doing so would result in undesirable effects that outweigh the benefits of a strict adherence to experience rating.

RECOMMENDATIONS

Based upon the preceding, our recommendations are:

1. The classification of extended benefits be changed from nonchargeable to chargeable benefits.
2. If, in the future, the other categories of noncharged benefits result in material benefit costs, serious consideration should be given to their classification as chargeable benefits.
3. Material benefit costs arising from any future broadening of benefit provisions should be classified as chargeable benefits, unless there is specific and convincing evidence that doing so would be undesirable.