

# Financing Unemployment Insurance in Illinois

## National Employment Law Project

### Executive Summary

In this briefing paper, NELP shows that the current unemployment insurance (UI) solvency crisis in Illinois is due to imprudent decisions made in the 1980s and ignored since that time. At that time, Illinois adopted a "pay as you go" UI financing regime. As a result, Illinois has had one of the most insolvent UI programs in the nation for fifteen years.<sup>1</sup> Structural flaws in pay as you go financing, not a relatively mild recession, have produced the current UI solvency crisis facing the state. With federal borrowing to ensure continued payments of UI benefits predicted this year, these flaws in Illinois' UI financing structure should come to broader attention so they can be properly addressed.

Returning to a policy of forward funding of UI is an essential step to restoring sound UI financing and avoiding future UI trust fund solvency crises in Illinois. The solvency crisis of 2003 is an opportunity to act to limit federal borrowing in coming years and take steps to reach financial self-sufficiency before the next economic downturn. Restoring UI financial solvency as soon as feasible means that federal interest on loans and tax surcharges to repay federal loans can be limited or avoided over time. In addition, returning to forward funding (sometimes referred to as a rainy day fund) will take better advantage of federal interest payments as a means of paying for UI benefits in contrast with the current policy's extensive reliance on employer tax contributions.

What are the impacts of the current state policy of keeping Illinois UI trust fund levels low? First, the Illinois Department of Employment Security projects that Illinois will borrow funds from the federal government in 2003 and for coming years to maintain state UI benefit payments. Second, UI solvency taxes as well as federal interest payments are a real possibility in subsequent years to repay these loans. Third, state UI payroll tax increases are going to occur automatically under our current law despite the state's continuing economic woes. And, finally, UI benefit restrictions are being urged by some despite predicted high jobless rates for the foreseeable future.<sup>2</sup>

With its current UI solvency crisis, Illinois faces unpleasant options. Any search for solutions should be informed by an understanding of the factors contributing to the crisis, the policy options available to address the crisis, and the advantages and disadvantages built into those competing options.

### Restoring Forward Financing of UI Trust Funds in Illinois

There are several policy recommendations that will put Illinois back on the road to responsible UI financing. Most importantly, Illinois should return to the traditional forward funding, or rainy day fund, approach to UI financing. Under this approach, UI payroll taxes are accumulated in a state's UI trust fund during economic good times in order to pay higher benefit costs during downturns. In reversing course, UI financing policies long recommended by UI experts and followed by most other states should be adopted in Illinois.

Forward funding of UI will provide Illinois with considerable rewards. These include (1) reducing the overall UI financing burden from employer payroll tax contributions by increasing the share of benefits paid by federal interest on trust fund reserves, (2) limiting risks of future borrowing and resulting interest and loan

repayment costs, (3) ensuring that jobless workers are better protected from economic insecurity, (4) providing a less volatile UI tax structure over a business cycle, and (5) addressing inequities in the current experience rating regime between high-cost and low-cost employers.

### **UI Financing Recommendations**

As we explain in this briefing paper, in order to restore forward funding and reach trust fund solvency, Illinois needs to adopt the following measures:

- Raise the \$9000 taxable wage base several thousands of dollars, perhaps in steps. This will produce added revenue and broaden the UI financing base. It will also lower employer payroll tax rates over the long run as these rates apply to a higher proportion of total wages.
- Adjust taxable wage base automatically and annually to reflect growth in wages. Eighteen states have annually indexed taxable wage bases. This will keep the taxable wage base growing in line with future increases in wages in order to avoid future insolvency.
- Set a trust fund solvency target that increases with wage growth by linking it to total state wages, rather than a target expressed in terms of fixed amount of dollars (currently \$750 million). This will ensure trust fund targets rise along with wages and the state's economy.
- Set a trust fund target that provides meaningful solvency--somewhere around 2 or 2.5 percent of total state wages. Abandon "pay as you go" financing and ensure that federal borrowing and interest payments are avoided in future mild recessions and limited in severe downturns.
- Set a minimum tax rate around 0.5 percent and exempt firms at the minimum rate for five years or more from paying the account building rate. In effect, this would give lower-cost employers a modest tax break, while eliminating the current, token 0.2 percent minimum rate. Over the longer run, this recognizes that all employers are insured and should pay something for that insurance, but that employers that have not laid off employees are not responsible for rebuilding the fund's balance.
- Consider adjustments to the current maximum state rate, especially if there are large numbers of firms with at the current maximum rate that are being subsidized by lower cost firms. Higher maximum rates enable a state to limit the shifting of UI payroll tax burdens from high-cost employers to other employers, making experience rating more effective and permitting faster recovery of trust fund balances.
- Focus on building solvency and reacting to economic downturns prior to downturns, rather than during or just after downturns. Businesses can better afford UI taxes while profitable and the state lacks the will to impose higher taxes during recessions as required by Reduce or eliminate reliance upon features like the State Experience Factor and account building rates that are supposed to increase taxes during and after a recession.

–Briefing Paper–  
**Financing Unemployment Insurance in Illinois**

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**Illinois UI Trust Fund Reserves—Among the Lowest in Nation**

The Illinois unemployment insurance (UI) trust fund balance at the end of December 2002 was \$448 million.<sup>3</sup> Depending upon the measure of trust fund solvency adopted, the Illinois trust fund balance ranked Illinois 48th, 49th, or 51st of 53 UI jurisdictions. (D.C., Puerto Rico, and the Virgin Islands are treated as "states" in our UI system.) Illinois has had a similarly low ranking for over a decade. Federal loans are expected in order to maintain UI benefit payments in 2003 and 2004. The box below explains the terminology of UI solvency measurement and Illinois' low ranking in more detail.

**Three Ways to Analyze UI Trust Fund Solvency**

*The following terms are commonly used to analyze UI trust fund solvency:*

*The **Reserve Ratio** or **Trust Fund as Percent of Total Wages** is a state's trust fund balance as a percent of total wages for the past 12 month period. This comparison of trust fund reserves with state wages compares the size of the trust fund balance to the risk being insured by unemployment insurance (loss of wages). Reserve ratios are useful because they reflect the growth of a state's economy. **Illinois' trust fund had a reserve ratio of 0.24 at the end of 2002, ranking 48th of the 53 UI jurisdictions.***

***Cost multiples** compare the size of past UI benefit payments in a twelve-month period to the trust fund balance. There are two cost multiple benchmarks in common use.*

*A **High Cost Multiple (HCM)** of 1.0 means that a state has one year's reserves at its historically highest level of benefit payments without relying upon UI payroll tax revenues. An HCM of 0.5 converts to six months, and so forth. **The HCM in Illinois at the end of 2002 was 0.09, ranking 49th of 53 jurisdictions.** Following the early 90s recession, the HCM for Illinois peaked at 0.44 in 1999. In the 1950s, an HCM of 1.5 was widely accepted as a prudent level of UI trust fund reserves.*

*The **Average High Cost Multiple (AHCM)** was adopted in the 1990s following criticism that HCMs were too ambitious for states to meet. A state's AHCM is the average of the three most recent high cost calendar years that include either 3 recessions or at least 20 years of payment history. The Advisory Council on Unemployment Compensation, a federal advisory panel, recommended in 1995 that states maintain a pre-recession AHCM of 1.0. **Illinois' AHCM was 0.10 at the end of 2002. This ranked 51st of 53 states.***

While Illinois' low ranking position in terms of UI trust fund solvency is not new, current high levels of UI benefit payments are making it crystal clear that serious misjudgments were made when Illinois abandoned forward funding of its trust fund balances in the late 1980s. In order to explain those misjudgments, we now explore the background of UI financing in Illinois in some detail.

History shows that Illinois did not reach its current poor level of UI solvency as a result of the recent economic downturn and accompanying rise in UI claims. The roots of Illinois current UI financing predicament go back to the 1970s. At that time, Illinois took federal loans totaling \$13.8 billion overall to pay UI benefits from 1975 through 1986.

As in all states, UI benefits are funded in Illinois by a UI payroll tax, usually paid quarterly, by all private employers.<sup>4</sup> The state advises each employer of next year's tax rate prior to the start of the calendar year. Rates are assigned annually. As we explain later, this tax rate is determined by a combination of factors that relate to the trust fund's overall health and the extent of claims filed by jobless employees of the firm. All state UI tax revenues are deposited in an interest-bearing account maintained by the U.S. Treasury. UI programs are separate from the general fund of a state, and trust funds are legally dedicated to the payment of UI benefits under both state and federal law.

At first, federal trust fund loans needed by Illinois in the 1970s were interest-free. For the most part, Illinois took those loans but didn't address UI financing. Beginning in 1982, the federal government started charging interest on loans. As a result, Illinois was forced to begin its return to solvency. In order to address its UI solvency crisis, the state passed agreed legislation that reduced scheduled benefit increases and imposed UI eligibility restrictions in combination with UI payroll tax increases. The taxable wage base (that part of wages subject to UI taxes) was raised from \$7000 to \$8000 in 1983, to \$8500 in 1985, and to its current level of \$9000 in 1988.

As soon as the Illinois UI trust fund returned to a positive balance in 1987, the earlier solvency agreement was revisited and a new agreed bill passed the Legislature restoring some benefit cuts, setting a solvency target of \$750 million in trust fund reserves, and reducing future UI payroll taxes as trust fund balances exceeded the target. This agreement marked the beginning of pay as you go UI financing in Illinois.

Illinois clearly shifted its UI financing philosophy in 1987. It abandoned the traditional rainy day concept of building trust fund reserves big enough to carry the program through future recessions. Instead of trying to provide forward funding of its UI trust fund, Illinois began a UI financing regime we call "pay as you go."<sup>5</sup> By "pay as you go," we mean that UI tax contributions are big enough to cover UI benefit payments, but not sufficient to build UI trust fund balances. This can be clearly seen in Table 1. Since the end of the last recession in 1994, UI payroll tax revenues exceeded benefits paid in five years (1994 through 1998), while benefits exceeded revenues in four years (1999 through 2002).

As a result of its adoption of pay as you go financing, Illinois has had deliberately low UI trust fund balances for many years. Since recovering from its last UI solvency crisis and ending loans in 1987, Illinois slowly built its UI trust fund balance. However, as shown by Table 1, trust fund growth has been very gradual, with tax revenue roughly balancing benefit payments over time. Federal interest accounts for a good deal of the modest growth in the trust fund, especially after 1998.

**Table 1– Illinois Trust Fund Overview Since 1987**

Year	End of Year Trust Fund Balance (000s)	Regular Benefits Paid (000s)	Payroll Tax Revenues (000s)	Federal Interest (000s)
1987	\$313,649	\$784,660	\$1,211,032	\$14,296
1988	\$823,625	\$690,515	\$1,154,435	\$47,726
1989	\$1,268,153	\$738,737	\$1,097,209	\$92,715
1990	\$1,459,282	\$908,189	\$984,788	\$120,858
1991	\$1,172,283	\$1,272,517	\$886,606	\$109,944
1992	\$847,622	\$1,277,517	\$919,619	\$74,972
1993	\$851,918	\$1,185,772	\$1,122,959	\$59,686
1994	\$1,247,066	\$1,043,863	\$1,371,685	\$67,641
1995	\$1,629,210	\$1,075,674	\$1,367,931	\$98,064
1996	\$1,638,560	\$1,220,522	\$1,126,071	\$110,545
1997	\$1,742,968	\$1,109,826	\$1,118,463	\$112,182
1998	\$1,928,620	\$1,042,860	\$1,138,916	\$121,698
1999	\$2,041,984	\$1,180,805	\$1,165,699	\$130,148
2000	\$2,091,829	\$1,226,193	\$1,146,581	\$135,674
2001	\$1,382,445	\$1,919,978	\$1,060,542	\$115,441
2002	\$1,111,069	\$2,478,359	\$1,123,956	\$9,612

As a result of the rough balance of revenues and benefits maintained by Illinois' pay as you go UI financing regime, at the end of 1999, after five years of a booming 90s economy, Illinois had a trust fund balance of \$2.042 billion. While this was a considerable increase in total dollars, this 1999 trust fund balance still only ranked Illinois 43rd, 47th, and 49th on the three common measures of UI trust fund solvency (see box above). Measured in terms of state total wages, the Illinois 1999 trust fund reserve ratio was 1.21 percent of total wages. In 1989, the state's trust fund reserve of \$1.268 billion was 1.25 percent of total wages. In other words, Illinois' trust fund gained no solvency ground in the 90s, its most prosperous economic decade on record.

**"Pay As You Go" Financing – Rationale for Lower UI Taxes**

Illinois achieved its dubious UI financing record through a combination of falling UI taxes, a stagnant UI taxable wage base, and fixed trust fund solvency targets. Each of these elements were adopted as part of what is known as "flexible" or "pay as you go" financing in the late 1980s. As a result, Illinois designed its UI trust fund and payroll taxation regime to keep its trust fund at modest levels in order to keep UI payroll taxes low.

Table 2 shows that Illinois succeeded in lowering UI taxes. Tax rates on total wages reflect employers' UI costs as a portion of their overall labor costs. Average UI taxes in Illinois on total wages were at 1.1 percent of total wages in 1994 (at the end of the last recession). UI taxes fell to 0.64 percent of total wages in 1999, 0.57 percent in 2000, and 0.52 percent in 2001. Payroll tax rates are estimated at 0.6 percent of total wages for 2002.

**Table 2 — Illinois UI Payroll Tax Rates**

Year	Average Tax Rate on Total Wages
1987	1.35
1988	1.21
1989	1.07
1990	0.88
1991	0.79
1992	0.81
1993	0.98
1994	1.10
1995	1.01
1996	0.78
1997	0.73
1998	0.68
1999	0.64
2000	0.57
2001	0.52
2002	0.6 (Estimate)

Under pay as you go financing, higher taxes are supposed to kick in and cover the higher benefit costs being experienced. In Illinois, a solvency target of \$750 million was adopted in the 1988. Once the trust fund drops below this target level, higher taxes are supposed to kick in to collect more revenue. Taxes are already higher in 2003 as a result of looming insolvency. As intended under pay as you go financing regimes, they will rise further in coming years. Assuming that the Legislator lets the system work as intended, employers will pay higher taxes in the coming years to reflect the lower taxes paid from 1995 to 2002.

Perhaps more than any debate about UI financing terminology, the actual behavior of tax rates and the Illinois trust fund balance since 1987 demonstrates that the Illinois system is designed to have employers "pay as you go."

Tax rates fell after 1994 as a result of a number of factors. Because UI claims were low, experience rates fell in Illinois and most states. Tax rates fell in Illinois because the \$750 million trigger was exceeded in every year after its adoption. In addition, the Legislature passed a "bonus" tax cut in 1996. Through this combination of an improving economy and legislative tax reductions, UI taxes fell steadily after the early 1990s recession and its aftereffects worked through the UI financing system. Table 2 shows the significant declines in Illinois' UI tax rates since 1987.

The financing scheme adopted in Illinois in the late 1980s was a conscious departure from forward funding of UI trust funds. Under this traditional method of UI financing, trust fund reserves are collected during good economic times in order to cover higher benefit costs without having to immediately raise taxes to cover them.

Illinois consistently ranked among the bottom states in terms of UI solvency throughout the 1990s. When this was noticed from time to time, business groups and other believers in low UI payroll taxes denied that this was a concern. Some representatives of business advocated further UI tax cuts as recently as the spring of 2001. Some of these same groups and individuals are now saying that UI benefits should be cut to avoid higher taxes, rather than letting "pay as you go" operate as intended by raising employer taxes.

### **The Hidden Costs of Pay As You Go Financing**

There is little question that "pay as you go" UI financing was essentially an outgrowth of supply-side theories providing a rationale for all interested parties to get what they wanted in the short term while hoping that long-term consequences would never happen. Supporters of pay as you go financing argued that large UI trust fund reserves were economically inefficient. In economists' terms, these funds represented a lost "opportunity cost" that were better used elsewhere. Employers and most in state government wanted lower UI taxes. Many in the legislature were willing to see reduced UI taxes so long as UI benefits were not cut as well. Labor reluctantly accepted the pay as you go scheme in order to avoid more painful ways for workers to contribute to restored solvency, such as benefit freezes or eligibility restrictions. The result was the elimination of forward funding of trust fund reserves from Illinois UI financing.

Now the consequences of pay as you go financing in Illinois have come home to roost. As a result, there are a number of less than desirable options facing Illinois. UI taxes increased automatically in 2003 as a result of the greatly increased UI claims experienced with our economic slump. However, statutory caps on annual tax increases, lower maximum tax rates, and Illinois low taxable wage base keep Illinois from collecting revenues sufficient to ensure UI solvency. This dire situation may last for many years, barring an unexpectedly quick and robust economic expansion.

Of course, it is bad economic policy to increase UI taxes during economic slowdowns, but these increases are an intended result of pay as you go financing.<sup>6</sup> In addition, under current law, UI weekly benefits will be reduced if the trust fund stays below statutory trigger levels. Again, reducing UI benefit levels during a period of high unemployment is bad economic policy, not to mention bad politics. To avoid these bad things during economic downturns, forward financing is the accepted policy followed in most states.

Illinois also lost hundreds of millions of dollars in federal interest payments over the 90s by maintaining a lower UI trust fund balance. As noted, UI trust fund balances receive federal interest from the U.S. Treasury. For example, in 1999, Illinois' UI trust fund earned \$128.5 million dollars in federal interest

payments and another \$119.1 million was earned in 1998. If the state's UI trust fund had been built to more traditional, higher reserve levels, Illinois would have collected hundreds of millions more in federal interest payments during these good economic times (see box).

### **Lost Federal Interest—A Hidden Cost of Pay As You Go Financing in Illinois**

*One way of estimating the amount of federal interest lost in Illinois as a result of not building trust fund reserves during the 1990s is to use the trust fund's actual balance in particular years and the actual federal interest paid in those years as a basis for the estimate. In 1998, for example, the Illinois trust fund balance was \$1.928 billion and federal interest paid was \$122 million.*

*1998's end of year trust fund balance produced an Average High Cost Multiple (AHCM) of 0.5, while the AHCM for all states that year was 0.94. Assuming that the Illinois trust fund was closer to an average sized trust fund in 1998, it's actual balance would have roughly double with an AHCM closer to 1.0. Using this method, with all other factors being equal, **federal interest would have been \$240 million in 1998 alone.***

*Assuming that Illinois' trust fund balance was double its actual balance and disregarding the impact of interest compounding, **federal interest lost from 1998 through 2001 would have been equal to the \$500 million in federal interest actually paid to Illinois in these four years alone.** In coming years, Illinois employers will bear a bigger UI payroll tax burden as a result of foregone federal interest payments since 1994. Maintaining pay as you go financing will continue the policy of paying UI benefits by relying mostly on UI payroll taxes while losing out on federal interest.*

See Table 1 for specific amounts of annual federal interest paid.

Illinois employers now must pay higher state UI payroll taxes to finance UI benefit payments because of the loss of federal interest resulting from lower trust fund reserves in the 1990s. Federal interest is effectively paying for UI benefits in other, more solvent states. Illinois employers now will pay all or most of the cost of interest on federal UI loans in coming years, resulting in a double whammy in terms of lost federal interest during the late 1990s combined with payments of federal interest on loans in coming years. The loss of federal interest is never mentioned by proponents of flexible financing and is usually not properly considered by policy makers adopting these UI financing regimes.

If Illinois maintains adequate UI trust fund reserves under a rainy day fund approach to UI financing, a higher proportion of benefit payments would be paid with federal interest, rather than state UI payroll taxes. **If Illinois had had reserves equivalent to 2 percent of payrolls in 1999, for example, federal interest payments would have approached \$300 million in that year, or roughly 25 percent of benefit payments in 1999.** As a result of pay as you go financing, on a continuing basis Illinois employers pay for a higher proportion of UI benefits with payroll tax contributions, rather than taking advantage of federal interest payments.

A third negative impact of Illinois' "pay as you go" financing is that a \$376 million federal Reed Act distribution in March 2002 has simply been absorbed into the Illinois trust fund. While offsetting some employer taxes for 2003, in other more solvent states Reed Act funds are available to pay for UI administration, technology, and one-stop administrative improvements as well as UI eligibility expansions. In contrast, the transferred federal Reed Act funds are not available to Illinois policy makers. The loss of Reed Act funds represents another hidden cost of pay as you go financing.

In summary, Illinois adopted a program of pay as you go financing in order to have lower UI payroll taxes beginning in 1987. The state's employers are now paying hidden costs for these lower taxes because Illinois lost hundreds of millions of dollars in annual federal interest payments since the early 1990s recession. Beginning in 2003 and continuing in future years, employers will pay higher UI payroll taxes and millions of dollars in federal interest on loans needed to pay UI benefits during the ongoing job slump. Unless Illinois employers want to continue paying these hidden costs in future economic downturns, 2003 offers a good opportunity to return to forward financing of UI.

### **Steps to Restoring Sound UI Financing in Illinois**

Many of the policies recommended here to gain unemployment insurance solvency and restore sound UI financing in Illinois are evident once the basics of UI financing are better understood. This final section is a more detailed explanation of UI financing, providing additional support for our policy recommendations.

UI payroll taxes are traditionally determined by three elements.<sup>7</sup> First, the "taxable wage base" is that portion of wages subject to taxes under state law. UI payroll taxes are imposed only on those wages below the taxable wage base. Wages above the taxable wage base are not taxed. Illinois' current taxable wage base of \$9000 was set in 1988 and has remained unchanged since that time. Second, employers are assigned a tax rate to apply to taxable payroll in a year based upon experience rating. Experience rating in part sets taxes based upon past benefits paid to jobless employees of a firm. Third, Illinois adjusts its tax rates based upon the trust fund target, set at \$750 million in 1988.

Currently, the minimum UI tax rate applied to this wage base is 0.6 percent while the maximum tax rate is 7.2 percent. Illinois also has a provision that limits any business with a payroll under \$50,000 a quarter to a maximum tax rate of 5.4 percent.

#### *Experience Rating*

A basic concept of UI financing is that UI payroll taxes are "experience rated." Under experience rating, an individual firm's payroll tax rate is set by a combination of two main factors. One factor depends upon the UI benefit claims paid to laid off workers from each firm (termed the benefit ratio in Illinois). A rough analogy is the practice of raising automobile insurance rates if a driver files a claim after an accident. All private employers have accounts maintained by the Illinois Department of Employment Security that track their UI benefits paid to laid off employees (called benefit charges) and their payrolls. Illinois also offers experience rating by industry groupings in some cases. New employers pay a set rate until they have three years of payroll records sufficient to permit a specific rate determination for the firm.

No state has totally effective (in other words 100 percent) recovery of benefit costs through experience rating. There are several reasons for this. First, maximum tax rates prevent the recovery of some benefit charges. Second, taxes are paid only on taxable wages, so tax contributions simply can't keep up with benefit payments. Third, employers go out of business before repaying benefit charges. Fourth, some benefits are paid in error and not recovered. Fifth, benefits paid for some types of separations other than layoffs are "non-charged" by law. For all these reasons, all contributing employers' UI tax rates include other elements beyond those determined by solely by experience rating in order to pay these costs of the trust fund.

#### *Tax Rates and Trust Fund Solvency*

The other factors in setting tax rates take into account the overall health of the state's UI trust fund (called

the state experience factor and fund building rate in Illinois). The experience factor is the ratio of benefits paid over a prior 3-year period to net trust fund revenues over a similar 3-year period. This unadjusted experience factor is then modified according to the amount by which the trust fund exceeds a target of \$750 million. In addition, a statutory limit prevents the experience factor from increasing more than 10 percent in any single year. In brief, the bigger the trust fund balance, the lower the state experience factor.

In addition, Illinois has a fund building rate that is intended to rebuild fund balances quickly and acts as a backstop to the state experience factor. Illinois currently has a 0.4 percent fund building rate (in other words, the minimum tax rate in Illinois would be 0.2 percent and the maximum tax rate would be 6.8 percent, but for this added 0.4 fund building rate in 2003). In effect, a firm in Illinois begins with a 0.2 percent tax rate, which is increased by the state experience factor and the fund building rate to determine an annual rate for the firm. That rate is then applied to the taxable wage base (first \$9000) of covered wages for each of the firm's employees. Taxes are usually paid quarterly.

Finally, Illinois has a federal penalty tax avoidance surcharge of 0.2 of total wages paid in the previous calendar year that is imposed if the trust fund falls below \$80 million on May 15 of any year. There is no surcharge in 2003.

#### *Taxable Wage Base*

State UI payroll taxes are imposed only on wages that fall within the taxable wage base. Illinois has a taxable wage base of \$9000. The majority of states have set their taxable wage bases within a few thousand dollars of the \$7000 federally-required minimum tax base, but a significant minority of have raised their UI taxable wage bases. Nine states have taxable wage bases above \$20,000. Hawaii's taxable wage base of \$30,200 is currently highest in the nation. Alaska, Idaho, Minnesota, Nevada, New Jersey, Oregon, Utah, and Washington all have taxable wage bases over \$20,000. Iowa's tax base is currently at \$18,600. With the exception of Minnesota (which has flexible financing), all these states are riding through the economic downturn without facing the sort of trust fund solvency crisis faced in Illinois.

Eighteen states adjust their taxable wage bases in line with the growth in state average wages. In nearly all cases, these states have indexed their taxable wage bases to average statewide wages. Indexing the taxable wage base means that the portion of wages that is subject to UI taxation keeps pace with the growth in wages. Since benefit levels rise with wages, the financing of benefits should increase in line with growth in wages as well.

Low taxable wage bases keep UI financing on a narrow wage base and make experience rating less effective. For example, in Illinois an employer that lays off a large portion of its workforce and has its UI tax rate set at the maximum rate cannot pay UI taxes on more than the first \$9000 in wages for each of its remaining employees (around \$600 in 2003). So, if our hypothetical employer has laid off one third of its workforce, it will be difficult or impossible for experience rates to recapture those benefit charges through higher taxes for many years, if at all. For that reason, there will be a large amount of UI benefits that cannot be effectively charged to that employer in 2004, 2005, and so on. As a result, the overall trust fund balance is lowered and tax rates on all employers must be raised through the state experience factor in order to recover these ineffectively charged taxes.

Taxable wage base levels, in combination with the maximum UI tax rates, determine how quickly a state's trust fund can recover from higher UI claim payments during a recession.<sup>8</sup> An ability to recover promptly from higher benefit claims increases a state's ability to limit the size and duration of federal trust fund loans

and to repay loans. A state's taxable wage base also needs to keep pace with growth in wages or the ability of its payroll taxes to sustain UI financial solvency over time is negatively impacted.<sup>9</sup>

Illinois' taxable wage base has not kept pace with the growth in wage levels and the size of the economy. It was set in 1988 and has not been adjusted since. In 1988, the ratio of taxable wages to total wages was .37. By the third quarter of 2002, the ratio of total wages to taxable wages was only .21. This represents a 43 percent growth in total wages while taxable wages remained stagnant. Considering that the ratio was only .37 at the time of its last increase in 1988, an upward adjustment to 50 percent of statewide average wages should be considered. A significant increase in the taxable wage base for 2004 is an important step toward returning to forward funding.

In order to restore and ensure the financial health of its UI trust fund, **Illinois should significantly raise its taxable wage base. Just as importantly, the taxable wage base should be indexed to future growth in wages.** A higher taxable wage base is one of the most important measures that Illinois can take to restore the UI trust fund balance. In the longer term, there are a number of advantages in raising the taxable wage base. Having a higher taxable wage base will reduce overall UI tax rates, reduce cost shifting between low wage and high wage employers, and limit the subsidization of higher cost firms by lower cost employers.

#### *Tax Rates*

The second basic element of UI financing is the tax rates applied to the taxable wage base. As we noted earlier in our discussion, state UI payroll tax rates fell significantly in Illinois since the 1987 adoption of pay as you go financing. UI taxes in Illinois fell consistently as a percent of total wages from 1987 until 2002, with the exception of the post-recession years 1992 through 1994 (see Table 2). Over this time, taxes on total wages fell from 1.35 percent of wages in 1987 to 0.52 percent of wages in 2002, more than a 60 percent reduction in effective tax rates over these 15 years. As we explain, Illinois needs to address both its minimum and maximum UI tax rates.

The range of tax rates within a state is essentially a political balancing act. In policy terms, we are largely concerned that adequate revenues are collected to finance a good UI program and forward funding is restored. Concerns about equity among employers and the distribution of tax burdens within the employer community should be weighed when considering UI tax policies.

In order to better assess the steps needed in order to return to solvency in Illinois, NELP obtained information from U.S. Department of Labor on the distribution of employer tax rates in 2002. USDOL provided us with information on the number of firms paying taxes at each tax rate in increments of 1/10 tenth of a percentage point. Last year there were 198,457 contributing employer accounts in Illinois. Of these, **146,740 employers (or 73.9 percent) paid a minimum tax rate at our near 0.6 percent in 2002.** This translates to a tax bill of \$54 a year for state UI taxes for almost three quarters of Illinois employers. Fewer than 6400 employers were paying the maximum tax rate of 6.8 percent of taxable payrolls (\$612) in 2002.

The Illinois tax rate distribution is the most heavily skewed toward the lower tax rates of the dozen or so states that we have studied. Tax reduction measures taken so far have resulted in a situation where the lion's share of Illinois employers pay low UI payroll taxes that have not provided sufficient revenue to support benefit levels. As a result of the pay as you go regime in the 1990s, higher taxes now must occur if federal interest payments for loans and additional borrowing are going to be limited in coming years.

Maximum tax rates effectively determine the extent to which seasonal and other high-cost employers are subsidized by lower cost firms. In other words, if maximum rates are too low (especially when combined with low taxable wage bases), some firms essentially subsidize their wages with UI benefits payments during slack periods that cannot be recovered later through experience rated taxes assessed against that firm. In addition, having an experience rating formula that actually applies higher tax rates to higher cost employers is necessary if trust fund solvency is going to be maintained. As we have noted, to the extent taxes don't capture costs from higher cost employers, other Illinois employers then pay the cost of these charges.

Federal law requires that states have a maximum tax rate of at least 5.4 percent. A number of Midwestern states have higher maximum tax rates than Illinois (currently 7.2%), including Wisconsin (9.75%), Minnesota (9.07%), Michigan (8.4%), Ohio (8.1%), and Iowa (7.5%). With the exception of Minnesota, none of these states are currently facing severe solvency challenges similar to Illinois. (Like Illinois, Minnesota has flexible financing.)

Employer groups rhetorically support experience rating and economists claim that it modestly reduces unemployment. Low taxable wage bases and lower maximum tax rates limit the effectiveness of experience rating and lead to lower cost employers subsidizing higher cost employers. This happens because experience rated increases on employers that layoff a significant portion of their work forces cannot recover the benefit charges when limited by modest maximum tax rates applied to a low taxable wage base.

**With significant financing burdens facing the Illinois UI program in the coming years, the maximum tax rate should be adjusted upward, in coordination with the degree of increase in the taxable wage base. In addition, experience rate components of the tax formula should be reexamined to find out why so many employers have minimum tax rates and to ensure that firms' costs are matched with contributions over time. The combined impact of these two steps should make an important contribution to the recovery of trust fund solvency.**

Zero minimum taxes are permitted by federal law. Zero or near-zero minimum tax rates were widely adopted in many states

during the 90s. Zero or extremely low minimum tax rates violate social insurance principles. That is, low rated employers are insured without paying a premium. While politically popular, zero or token minimum rates are not good for UI trust fund solvency because a majority of firms in most states pay at or near the minimum UI tax rate. In addition, all employers derive a benefit from the existence of UI benefits and its positive impact on the economy and all should pay some contribution toward trust fund solvency.

Currently, Illinois has a statutory minimum tax rate of 0.2 percent (in the absence of any fund building rate). This is effectively a zero minimum rate. For the reasons already discussed, **Illinois should maintain a minimum tax rate of at least 0.5 percent**, or somewhat higher, perhaps 1.0 percent, depending upon what cost simulation models reveal about solvency needs in the coming years. Adopting a minimum tax rate that is not a token rate is another important step to returning to UI solvency.

#### *Consideration of Low Cost and High Cost Employers*

Low taxable wage bases impose a higher level of effective taxation on employers (and to a degree on employees) in lower-wage occupations. As a result, low-income, part-time, or multiple jobholders' wages are subject to disproportionately higher UI taxes. This is because all or a majority of low-wage workers' earnings are subject to UI taxation, while a smaller proportion of higher paid individuals' wages are taxed.

Similarly, employers paying low-wages have UI taxes as a higher proportion of labor costs.

While we are skeptical about the virtues of experience rating, cost shifting of solvency taxes from higher-cost to lower-cost employers, especially if an adequate minimum rate is established, undercuts experience rating. The degree to which this is happening is difficult to judge without added information.

Policy makers need to recognize that the current fund building rate factor is insufficient to rebuild the trust fund's balance in order to minimize future federal borrowing. For that reason, meaningful increases in the taxable wage base and the minimum and maximum tax rates are an effective means to avoid triggering the federal penalty tax avoidance surcharge. Indeed, to the degree there are either overly modest or no increases in the taxable wage base and the range of tax rates, lower cost employers in Illinois will continue subsidizing higher cost employers.

Finally, in the event that Illinois doesn't get its own UI financing house in order, the federal government will eventually step in and impose surcharges on the federal FUTA tax. Again, that means that lower cost employers will subsidize higher cost employers in restoring financial health to the trust fund, since these federal taxes are imposed at a flat rate on all employers.

#### *Restoring Forward Funding of the Trust Fund*

Illinois has a number of other features in its current financing regime that have combined to prevent its experience rating system from building adequate trust fund reserves. First, Illinois has a UI trust fund "target" of \$750 million. This target was set in the late 1980s when wages were considerably lower than today's wages and salaries, as were UI weekly benefit amounts. By setting a target in terms of a fixed amount of dollars, rather than as a percent of total payrolls, Illinois was asking for trouble. **The current trust fund target should be repealed.** It is too low and doesn't keep pace with wage growth.

Better policy dictates that states express solvency targets in terms of a percentage of payrolls, rather than a fixed dollar amount. **Illinois should adopt a goal of eventually reaching a trust fund balance equal to around 2 or 2.5 percent of total payrolls.** In 2002, this would have translated to about \$5 billion. A backup solvency trust fund target of an AHCM of 1.0 should also be adopted. These targets would recognize that Illinois is returning to forward funding of its UI trust fund in order to avoid future solvency challenges and the hidden costs of pay as you go financing.

While the trust fund balance target we're recommending is a bigger figure in dollars than any current trust fund balance in other states, \$5 billion is only double the \$2.478 billion in benefit payments made in the state in 2002. While dramatically higher than past years, 2002 saw unemployment levels at 6.3 percent, far below the historic highs of the 1970s and 1980s. In addition, other states' trust fund balances have been impacted by the recession as well, so their current levels is not a valid benchmark in our view.

Again, what counts isn't the size of the trust fund in dollars, but its relationship to the wage loss insured and expected benefit payments. Illinois ranks fourth or fifth in terms of the size of its economy and total wages, and its trust fund should rank in the top five as well. Adopting a trust fund target of 2.0 percent to 2.5 percent of total wages and an AHCM of 1.0 should result in a trust fund that produces significant federal interest payments to the trust fund and reduces or eliminates future federal loans.

In restoring forward funding, Illinois should not only repeal the dollar target of \$750 million, but the related tax cut and tax increases triggered by \$50 million increments. Instead of rapid increases and reductions pivoting around a single trust fund target, tax rates should adjust much more gradually as the trust fund balance grows into the future. When the trust fund target is reached, tax schedules should be adjusted to slow, but not stop, the growth of the trust fund. The predominance of minimum-rate employers in the tax distribution also indicates to us that Illinois current rate structure isn't accounting for past layoffs and benefits in a way that captures costs of benefits. This needs further investigation and adjustment. Specific financing mechanisms to replace the pay as you go features adopted in 1988 can be designed based upon practices in other states and projections of future costs and tax rates.

In the future, policy makers and interested parties must recognize the importance of forward funding of UI and stick to recognized fundamentals of UI financing. This means that Illinois should not relax until its trust fund balance reaches at least 2.5 percent of total wages and its average high cost multiple (AHCM) is over 1.0. At that time, the financing regime can gradually relax tax rates, but not to the degree provided under the current, automatic trust fund target adjustments.

### **Conclusion**

Employers in Illinois accepted the lower taxes of the 90s under the mistaken assumption that UI trust fund reserves were no longer necessary, and as some even argued, undesirable. This regime has resulted in low UI taxes. Workers in Illinois effectively paid for a share of these tax cuts with continuing restrictions on UI weekly benefit calculations. Additional hidden costs were millions of dollars in lost federal interest payments and the inability to take advantage of federal Reed Act distributions in 2002. Future costs will include higher state UI payroll taxes, likely repayment of federal interest charges on loans, and potential state solvency surcharges or federal FUTA tax surcharges.

While there are no painless solutions to the Illinois UI financing dilemma, clearly the reasons why Illinois is in a predicament were foreseeable. Forward funding of UI trust funds avoids solvency emergencies, maximizes the use of federal interest for paying UI benefits in lieu of employer taxes, and promotes economic stimulation in recessions. By adopting policies like those outlined here, Illinois can return to sound UI financing practices and restore the solvency of its UI program.

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The authors thank Dia Cirillo of Work, Welfare and Families for her comments and suggestions.

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## Endnotes

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<sup>1</sup> The U.S. Department of Labor publishes quarterly data that consistently listed Illinois among the bottom states in terms of UI solvency.

<sup>2</sup> The range of policy options potentially includes benefit and eligibility restrictions as well as payroll tax increases. As we discuss in detail later, Illinois employers have enjoyed years of lower UI taxes under the present taxing regime, a so-called "pay as you go" scheme that was advocated by business groups and their supporters. Having dug the hole, so to speak, fairness and logic leads us to focus on employers to fill it. NELP issued a report in April 2001 that listed Illinois as one of five states that "have essentially squandered the opportunity which sustained economic growth has provided to prepare for an economic downturn." Marc Baldwin, Boom and Bust: Financing Unemployment Insurance in a Changing Economy (National Employment Law Project, April 2001), p. 17. The report continues, "It is at best dishonest for these states to ignore solvency thresholds in the effort to cut taxes, but now resort to solvency concerns in an effort to avoid benefit reform."

<sup>3</sup> All UI figures in this briefing paper are from the U.S. Department of Labor, Office of Workforce Security, Division of Fiscal and Actuarial Services. UI Handbook No. 394 is used for all years before 2002. UI Data Summary for the 4th quarter 2002, is used for 2002 data. Tax rates estimates are from UI Program Letter 35-02. For convenience, Illinois UI financing figures for 1987 through 2002 are assembled in a single table found at the end of this paper, along with a glossary of UI financing terminology.

<sup>4</sup> Only private employers must pay UI payroll tax contributions on wages. While some non-profit and local government employers elect to pay tax contributions, most non-profit and governmental employers are known as "reimbursing employers." Reimbursing employers are expected to repay the trust fund for UI benefits paid to laid off employees on a quarterly basis. In three states (Alaska, New Jersey, and sometimes Pennsylvania), employees pay a small employee contribution that is collected as a payroll tax.

<sup>5</sup> Another term used to describe this philosophy is "flexible" financing. In our view, "pay as you go" financing is a more assertive variant of flexible financing, which covers a wider variety of UI financing practices. Regardless of which term is used, there is no question that Illinois adopted a new UI financing philosophy in 1987 that represented an abandonment of forward financing, or so-called rainy day funding. For a general overview of flexible financing, see Wayne Vroman, *Topics in Unemployment Insurance Financing* (Upjohn Institute. Kalamazoo, Michigan, 1998), 35-61 and Mike Miller, Robert Pavosevich, and Wayne Vroman, "Trends in Unemployment Benefit Financing," in Christopher J. O'Leary and Stephen A. Wandner, ed., *Unemployment Insurance in the United States: Analysis of Policy Issues* (Upjohn Institute. Kalamazoo, Michigan, 1997), pp. 365-419.

<sup>6</sup> The federal advisory council warned in 1996: "The capacity of the UI system for economic stabilization is dependent upon the extent to which it is forward-funded. Under pay-as-you-go financing . . . few reserves are available to stimulate the economy when needed because trust funds are not being built up during periods of economic health." Advisory Council on Unemployment Compensation, *Defining Federal and State Roles in Unemployment Insurance* (U.S. Department of Labor, Washington, D.C., 1996), p. 31. To the degree that Illinois and other pay as you go states are forced to raise taxes during an economic downturn or jobless recovery, this undercuts the positive economic impact of UI benefit payments. For this reason, flexible financing undercuts national interests in the counter-cyclical performance of UI programs. See Vroman, *Topics in Unemployment Insurance Financing*, 72.

<sup>7</sup> There is a separate federal tax of 0.8 imposed on the first \$7000 of wages called the FUTA tax. This federal revenue pays for UI administration by state and federal agencies, provides loan funds for insolvent state trust funds, and pays the federal portion of benefit extensions.

<sup>8</sup> Wayne Vroman has examined the tax capacity of UI trust funds and their ability to recover from recessions, comparing 1986 and 1996. He found that tax capacity had declined over that period and that this decline was concentrated in states where the taxable wage base is not indexed. Vroman, TOPICS IN UNEMPLOYMENT INSURANCE FINANCING, 50-53.

<sup>9</sup> Phillip B. Levine, "Financing Benefit Payments," in Christopher J. O'Leary and Stephen A. Wandner, ed., *Unemployment Insurance in the United States: Analysis of Policy Issues* (Upjohn Institute. Kalamazoo, Michigan, 1997), pp. 333-334.

## Appendix — Illinois UI Financing Overview — 1987 to 2002

Year	End of Year Trust Fund Balance (000s)	Trust Fund as Percent of Total Wages	High Cost Multiple (1.0 = One Year)	Average Tax Rate on Total Wages	Taxable Wage Base	Regular Benefits Paid (000s)	Payroll Tax Revenues (000s)
1987	\$313,649	0.35	0.13	1.35	\$9,000	\$784,660	\$1,211,032
1988	\$823,625	0.85	0.32	1.21	\$9,000	\$690,515	\$1,154,435
1989	\$1,268,153	1.25	0.47	1.07	\$9,000	\$738,737	\$1,097,209
1990	\$1,459,282	1.36	0.51	0.88	\$9,000	\$908,189	\$984,788
1991	\$1,172,283	1.08	0.41	0.79	\$9,000	\$1,272,517	\$886,606
1992	\$847,622	0.74	0.28	0.81	\$9,000	\$1,277,517	\$919,619
1993	\$851,918	0.71	0.27	0.98	\$9,000	\$1,185,772	\$1,122,959
1994	\$1,247,066	0.99	0.37	1.10	\$9,000	\$1,043,863	\$1,371,685
1995	\$1,629,210	1.22	0.46	1.01	\$9,000	\$1,075,674	\$1,367,931
1996	\$1,638,560	1.16	0.44	0.78	\$9,000	\$1,220,522	\$1,126,071
1997	\$1,742,968	1.14	0.43	0.73	\$9,000	\$1,109,826	\$1,118,463
1998	\$1,928,620	1.17	0.44	0.68	\$9,000	\$1,042,860	\$1,138,916
1999	\$2,041,984	1.17	0.44	0.64	\$9,000	\$1,180,805	\$1,165,699
2000	\$2,091,829	1.13	0.4	0.57	\$9,000	\$1,226,193	\$1,146,581
2001	\$1,382,445	0.74	0.27	0.52	\$9,000	\$1,919,978	\$1,060,542
2002	\$1,111,069	0.24	0.09	0.6*	\$9,000	\$1,388,384	\$1,123,956

Prepared by the National Employment Law Project. For further information see [www.nelp.org](http://www.nelp.org). Sources: U.S. Department of Labor, Handbook No. 394 (1980 through 2001 data). 2002 and 2001 tax rates are from U.S. Department of Labor, UIPL 35-02. 2002 Data is from 4th Quarter 2002 UI Quarterly Data Summary, except for estimated tax rate for CY 2002 which is UIPL 35-02.

## **UI Financing Terminology**

### **AVERAGE HIGH COST RATE**

The average of the three highest calendar year benefit cost rates in the last 20 years (or a period including three recessions, if longer). Benefit cost rates are benefits paid (including the state's share of extended benefits but excluding reimbursable benefits) as a percent of total wages in taxable employment.

### **AVERAGE HIGH COST MULTIPLE (AHCM)**

Calendar Year Reserve Ratio (or "TF as % of TW"); divided by the Average High Cost Rate. An AHCM of 1.0 means that the trust fund reserve ratio is equal to the annual benefit costs of the average of the last three recessions. An AHCM of 0.5 translates to 6 months, and an AHCM of 1.5 is equivalent to 18 months reserves.

### **FUTA**

Refers to the Federal Unemployment Tax Act, including the net effective federal UI payroll tax of 0.8 percent paid by all covered employers on the first \$7000 of calendar year wages.

### **HIGH-COST MULTIPLE (HCM)**

"TF as % of TW" divided by the High Cost Rate. The High Cost Rate is the highest historical ratio of benefits to wages for a 12-month period. An HCM of 1.0 equals reserves sufficient to cover a year of benefit costs at the state's historical peak payment level.

### **INSURED UNEMPLOYED**

The number of weeks claimed for the time period reported. Used as a number representing those receiving UI benefits.

### **INSURED UNEMPLOYMENT RATE (IUR)**

The rate computed by dividing Insured Unemployed for the relevant time period by Covered Employment for the corresponding period.

### **TAXABLE WAGES**

Wages paid to covered employees that are subject to state unemployment insurance payroll taxes.