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FISCAL IMPACT REPORT

ORIGINAL DATE 02/08/13
 SPONSOR SFC LAST UPDATED 03/04/13 HB _____
 SHORT TITLE Unemployment Fund Contributions and Formula SB 334/SFCS
 ANALYST Aledo-Sandoval

REVENUE (dollars in thousands)

Estimated Revenue			Recurring or Nonrecurring	Fund Affected
FY13	FY14	FY15		
	*See Discussion	*See Discussion	Recurring	Unemployment Insurance Trust Fund

(Parenthesis () Indicate Revenue Decreases)

ESTIMATED ADDITIONAL OPERATING BUDGET IMPACT (dollars in thousands)

	FY13	FY14	FY15	3 Year Total Cost	Recurring or Nonrecurring	Fund Affected
Total		\$324.0		\$324.0	Nonrecurring	Federal Funds

(Parenthesis () Indicate Expenditure Decreases)

Relates to HB 329

SOURCES OF INFORMATION

LFC Files

Responses Received From

Economic Development Department (EDD)

Attorney General's Office (AGO)

Workforce Solutions Department (WSD)

No Responses Received From

Department of Finance and Administration (DFA)

SUMMARY

Synopsis of Bill

The Senate Finance Committee substitute for Senate Bill 334 proposes several major changes to the Unemployment Compensation Act. The committee substitute extends the current employer contribution schedule 2 through December 31, 2014 and replaces the reserve ratio system with a

benefit ratio system effective January 1, 2015. Section 3 of the committee substitute details the formulas for calculating employer contribution rates, employer's benefit ratios, and the reserve factor. The bill also describes a new method for assigning contribution rates for new employers based on an industry average and creates an excess claims premium.

Under the benefit ratio system proposed in the committee substitute, an employer's contribution rate is based on two components: an employer's benefit ratio and the reserve factor. The employer contribution rate is defined as the employers benefit ratio multiplied by the reserve factor.

Employer Contribution Rate = Employer's Benefit Ratio X Reserve Factor

The employer's benefit ratio is determined by dividing an employer's cumulative benefit charges during the preceding three years by the employer's total annual taxable payroll during the same time period.

Employers Benefit Ration = 3 yrs. of Benefit Charges / 3 yrs. of Taxable Payroll

The reserve factor will range between 0.5 and 4.0 and is based on the ratio of the fund balance to the funds needed to pay between 18-24 months of benefits at the average of the five highest years of benefits paid in the last 25 years (adequate reserve). The bill requires the secretary of the Workforce Solutions Department (WSD) to promulgate a rule to determine the reserve factor based on a formula proportional to the difference between the amount of funds available for benefit payout and the adequate reserve.

As in existing law, this bill caps the maximum employer contribution rate at 5.4 percent. This bill changes the minimum employer contribution rate from 0.03 percent to 0.33 percent. According to the WSD, this minimum contribution rate is sufficient to offset the costs incurred by the UI system that cannot be attributed to specific contributing employers.

Currently, new employer contribution rates are set at 2 percent for four years. Under this bill, an employer is considered a new employer if an employer has been a contributing employer for less than 2 years. The contribution rate for new employers under the committee substitute is based on an industry average. The bill also sets a 1 percent minimum contribution rate for new employers.

The excess claims premium, capped at 1 percent, is calculated by multiplying the benefit ratio in excess of 5.4 percent by 10 percent.

Background

Currently, New Mexico uses a reserve ratio formula to determine the appropriate employer contribution schedule (0-6) for a calendar year and employer contributions are assessed on the particular schedule based on an employer's individual experience rating. The reserve ratio depends on the fund balance on June 30th and covered wages at the end of the previous calendar year. The reserve ratio is basically a snap shot in time.

A chief complaint about the current employer contribution system is that the tax burden is not fairly distributed, especially among employers who run persistent deficits without increased costs beyond the cap of 5.4 percent. These employers are disincentivized from actively managing

their unemployment claims to prevent benefits going to individuals who are not eligible. Another complaint is that the current system has not been able to freely adjust based on the trust fund balance. During the economic downturn, schedules were frozen to reduce tax burdens on employers.

FISCAL IMPLICATIONS

The existing law states that UI contribution schedule 2 is in effect through December 31, 2013 and beginning with calendar year 2014 the contribution schedule would be determined by the reserve ratio formula. Based on the June 30, 2012 trust fund balance, schedule 6 would likely be triggered; a comparison of schedule 2 and schedule 6 in 2013 indicated an increase of approximately \$140 million in employer contributions is possible.

Most recent WSD projections estimate that a continuation of schedule 2 through December 31, 2014 would yield a 2014 year-end fund balance of \$141.9 million. According to the projection, schedule 2 is sufficient for the fund to remain solvent throughout CY2014.

The FY10-FY12 revenue look-back study generated by the WSD indicated that the majority, or approximately 60 percent, of all employers will fall at the minimum employer contribution rate of 0.33 percent under the proposed benefit ratio system. The remaining 40 percent of employers are basically evenly split between employers with contribution rates between 0.33 percent and 5.4 percent and those with contribution rates of 5.4 percent with excess claims premiums.

Based on the formula outlined in SB 334, the current adequate reserve requirement for the trust fund to cover benefit payouts for 18 months is \$418.5 million. The UI trust fund balance was \$44.3 million as of February 19, 2013.

Adequate reserve (sometimes also called the Average High Cost Multiple) is a commonly used actuarial measure of the UI trust fund adequacy. The Average High Cost Multiple (AHCM) provides an estimate of the length of time (measured in number of years) the current reserve in the trust fund can pay out benefits at historically high payout rate. The WSD calculated that at a fund balance of \$126.3 million, the AHCM is 0.45. Based on current data, an AHCM of 0.45 would only cover benefits for approximately five months. Beginning in 2019, the USDOL will require an AHCM of 1.0 for states applying for a Title XII advance.

Theoretically, the benefit ratio system seeks to build up an adequate trust fund reserve. Currently, nine states use benefit ratio systems for determining employer contribution rates.

Based on the three-year look-back study, the WSD provided the following revenue projections for the benefit ratio system per various reserve factors:

Reserve Factor	Est. Contribution Revenues (in millions)
1.50	\$199.1
1.75	\$219.7
2.00	\$238.8
2.25	\$256.4
2.50	\$272.9
2.75	\$288.1
3.00	\$302.2
4.00	\$349.2

A reserve factor between 2.50 and 3.00 would be necessary in order to bring in enough revenue to match current benefit payout of approximately \$64 million per quarter and begin to build up the reserves.

The average employer tax rate change from schedule 2 varies depending on the reserve factor chosen. The table below shows the average change from schedule 2 per reserve factor:

Reserve Factor	Average Tax Rate Change from Schedule 2
1.50	-0.20%
1.75	-0.11%
2.00	-0.03%
2.25	0.05%
2.50	0.11%
2.75	0.16%
3.00	0.21%
4.00	0.37%

Under the current contribution schedule 2 for 2013, the WSD estimates contribution revenues of \$306.3 million. Assuming a reserve factor of 3.00 is selected; revenues under the benefit ratio system are estimated at \$302.2 million. The formula specifics for determining the reserve factor are not detailed in the bill.

At a reserve factor of 3.00, on average, contributing employers will experience a 0.21 percent increase in their tax rate over their schedule 2 rates. However, the tax rate distribution under the benefit ratio system is expected to be more equitable. Under the benefit ratio system, employers with fewer benefit charges are taxed at lower rates and employers with higher benefit charges taxed at higher rates. According to the reserve factor 3 scenario provided by the WSD, nearly 23 thousand employers will experience a decrease in their tax rates, whereas employers with the highest benefit charges are likely to see tax rate increases up to 3.5 percent.

Under this bill, new employers, employers with less than 24-months of payroll and benefit history, are likely to experience a tax decrease from the current 2 percent contribution rate. According to data provided by the WSD, the average tax rate change for new employers is between -0.60 percent and -0.17 percent depending on the reserve factor.

According to the WSD, the tax reforms outlined in SB 334 would require design, programming, and testing in the newly launched tax system. The Department estimates a one-time cost of \$324 thousand for design, programming, and testing. Federal funds would be available to cover this cost.

SIGNIFICANT ISSUES

In 2012, the UI Advisory Council convened by the WSD examined reforms to the unemployment insurance system, including implementing a floor and ceiling mechanism, revamping the employer contribution schedule matrix, and setting a target fund balance. Participants included legislative fiscal staff and representatives from the Department of Finance and Administration (DFA), the business community and labor interests. Although no votes were

taken, this bill includes items reviewed by the council members. Nonetheless, converting to a benefit ratio system may involve risks to the unemployment trust fund and the UI Advisory Council was not presented with employer contribution revenue estimates for the benefit ratio system. Revenue estimates were provided to LFC staff after the committee substitute was introduced.

Reserve Factor

In regards to the reserve factor, the following is laid out in the bill:

- If the trust fund balance equals the adequate reserve, then the reserve factor is 1.0
- If the trust fund balance is greater than the adequate reserve, then the reserve factor would be set between 0.5000 and 0.9999
- If the trust fund balance is less than the adequate reserve, then the reserve factor would be set between 1.0001 and 4.0000

The committee substitute requires the Department to promulgate rules detailing a formula by which to determine the reserve factor. According to the bill, the reserve factor is to be set “in proportion to the difference between the amount of funds available for benefits in the fund, as of the computation date, and the adequate reserve.” This language is vague and does not provide sufficient guidance for setting the ratio for determining the reserve factor. The WSD contends that other states’ agencies set the formula for determining the reserve factor in rule and that this would provide the Department more flexibility than if the formula was in statute.

According to the WSD estimates, the difference in contribution revenues between a reserve factor of 1.50 and 4.00 is approximately \$150.1 million. The wide revenue range among reserve factors is concerning because the reserve factor is to be determined by an unknown proportion formula to be developed by the Department via rulemaking. The bill also does not provide the WSD with a time frame for achieving an adequate reserve. The bill, however, does require that the fund sustain an adequate reserve.

Tax Rate Caps

As stated in the background section, one of the chief complaints with the current reserve ratio system is that there are employers who disproportionately benefit from the overall rate cap of 5.4 percent. These employers incur benefit charges that far exceed the maximum rate of contributions. In 2011, there were approximately 3,800 employer accounts, or 12.1 percent of all accounts, which accounted for 85.6 percent of all the ineffective charges. Ineffective charges are charges where the employer contributed less to the fund than the unemployment claims paid out on their behalf. These employers were also responsible for 50 percent, or \$127 million, of all the benefits paid in 2011. This bill attempts to address this particular issue with the addition of the excess claims premium which provides for up to a 1 percent additional premium on employers whose benefit ratio exceeds 5.4 percent. So in effect, the highest tax rate a contributing employer could be charged is a combined total of 6.4 percent. A 1 percent cap on the excess claims premium may not provide sufficient incentive to the employers with ineffective charges to alter their business practices.

According to documents provided to the Unemployment Insurance Advisory Council, having maximum rates increase incrementally could provide a more equitable distribution of the tax liability and also prevent employers with fewer benefit charges from having to subsidize the ineffective charges resulting from the employers with the highest benefit charges.

An LFC brief prepared for a hearing in August 2012 stated that forty-two states and the District of Columbia have set maximum tax rates above 5.4 percent. States such as Massachusetts and Maryland have implemented some of the highest rates: 15.4 and 13.5 percent, respectively.

The Economic Development Department (EDD) states the propose changes to current law should provide employers more stability in budgeting for unemployment insurance and employers will be better able to reconcile their contribution rate with their actual experience. The EDD asserts that the system currently in place fails to fairly correlate an employer's claims experience with its tax rate and that the benefits ratio formula is more transparent to employers. The EDD also notes that employers will be able to identify what caused their rates to change. The cumulative changes should adjust the "health" of the trust fund which has been affected by the contribution schedules being legislatively frozen.

RELATIONSHIP

HB 329 also proposes to amend portions of the Unemployment Compensation Act.

AMENDMENTS

1. Increase the maximum employer contribution rate to a rate higher than 5.4 percent.

A cap higher than 5.4 percent would shift the tax burden to those employers with higher benefit ratios – the employers who use the fund more. If the cap is too low then high benefit ratio employers continue to be substantially subsidized by lower benefit ratio employers. Likewise, the lower the cap on the excess claims premium, the higher the amount of ineffective charges that will be subsidized by all employers. This raises equity issues because taxpayers are not being treated fairly.

2. Increase the 1 percent cap on the excess claims premium to at least 3 percent.

An employer contribution rate greater than 5.4 percent and an excess claims premium greater than 1 percent could contribute to a higher trust fund reserve which could lead to a lower reserve factor. In turn, a lower reserve factor could reduce the contribution rates for employers with lower benefit ratios.

3. Provide parameters for the proportion formula which is to be used in determining the reserve factor.

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